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IN THE

SUPREME COURT OF THE UNITED STATES

October Term, 1931

No. 270

THE PACIFIC CO., LTD.,
Appellant,

vs.

CHARLES G. JOHNSON, State Treasurer of the State of California,
Appellee.

BRIEF FOR APPELLEE

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No. 270

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vs.

CHARLES G. JOHNSON, State Treasurer of the State of California,
Appellee.

BRIEF FOR APPELLEE

FOREWORD

This appeal involves the constitutionality of that portion of the Bank and Corporation Franchise Tax Act of California (Statutes of California for 1929, page 19), measuring the amount of the State corporation franchise tax by percentage of net income and including within the income by which the amount of the tax is measured interest received from "Federal, State and municipal or other bonds."

Predicating its cause of action upon the alleged unconstitutionality of that portion of said act, appel-

lant brought this tax recovery proceeding. Appellee's demurrer to the complaint was sustained without leave to amend and judgment was thereupon entered against appellant. An appeal was then taken to the Supreme Court of California, which affirmed the judgment of the trial court.

The Pacific Co., Ltd., vs. *Johnson*, 81 C. D. 519, 298 Pac. 489.

Upon application to this court a writ of *certiorari* was allowed.

STATEMENT OF THE CASE

Appellant is now and during all of the times hereinafter mentioned was a California corporation engaged in the buying and selling of securities, including bonds of California improvement districts. As such it is subject to the payment of a corporation franchise tax in accordance with the provisions of section 16 of Article XIII of the Constitution of California and the Bank and Corporation Franchise Tax Act.

During the calendar year 1928 appellant received from California improvement district bonds issued prior to November 6, 1928, profits in the sum of $651,732.75 and interest in the sum of $167,324.11. Also, in that year appellant received interest of $2,624.07, on improvement district bonds issued after November 6, 1928.

That interest and those profits were set forth by appellant in making, in 1929, its return of its net

income for the calendar year 1928. In 1929 appellant involuntarily paid to the State its franchise tax based on the said net income, which included that interest and those profits. Appellant's claim for refund, based on the contention that the interest and profits were improperly included in the process of calculating appellant's State franchise tax, was rejected by the Franchise Tax Commissioner, whereupon this recovery action was filed under the authority of section 30 of the act.

In the State courts appellant complained of the inclusion of said profits, as well as said interest, in the tax base, but its objection with reference to the profits has been abandoned by appellant and is not before this court, probably on account of the decision of this court in

Willcutts vs. *Bunn,* 51 Sup. Ct. Rep. 125, 282 U. S. 216.

APPELLANT'S CONTENTION

Appellant's single contention is centered upon section 1¾ of Article XIII of the Constitution of California, which reads as follows:

> "All bonds hereafter issued by the State of California, or by any county, city and county, municipal corporation, or district (including school, reclamation, and irrigation districts) within said State, shall be free and exempt from taxation."

Appellant argues that the provision quoted established a contract between appellant and the State

of California granting complete tax immunity to the holders of the bonds in question and that the terms of the said Bank and Corporation Franchise Tax Act and their application by the State to appellant in the exercise of its corporate privileges, are such as to offend against section 10 of Article I of the Constitution of the United States.

APPELLEE'S CONTENTIONS

Appellee replies:

First: That the tax imposed under said Bank and Corporation Franchise Tax Act is an excise for the privilege of exercising corporate rights and privileges in California and is not a property tax.

Second: That section 1¾ of Article XIII of the California Constitution is an exemption from property taxes only; it does not express an obligation to exempt the bonds in question from taxation under the State Bank and Corporation Franchise Tax Act, and, consequently, there is no impairment of any obligation of any contract, and, therefore, no violation of section 10 of Article I of the Constitution of the United States.

Third: Assuming, without conceding, that the language of section 1¾ of Article XIII of the Constitution of California, adopted in 1902, comprehended an exemption from that kind of a tax provided for in said Bank and Corporation Franchise Tax Act, that exemption was withdrawn and eliminated by subsequent changes in the California Constitution.

A BRIEF HISTORY OF EVENTS PRECEDING THE ENACTMENT OF THE BANK AND CORPORATION FRANCHISE TAX ACT

This is the first case to bring the Bank and Corporation Franchise Tax Act before this court, and a brief reference at this point to matters preceding its adoption would seem to be in order.

The California Constitution was amended in 1910 to effect a separation of sources and to introduce variations from the *ad valorem* tax in the matter of State and local taxation. By that amendment section 14 was added to Article XIII, and a change was made in section 1 of that article to conform to the exceptions which section 14 created to the original, uniform, *ad valorem* tax system.

Confining our review to those features of the 1910 amendment pertinent to a consideration of this cause, that amendment directed the taxation by the State of the shares of stock of National and State banks at a stated percentage, subject to legislative change by a two-thirds vote of each house, of the value of the shares. The value of a share was the amount paid in thereon together with its pro rata of the accumulated surplus and undivided profits. The tax upon the share was in lieu of all taxes and licenses, State and local, upon such shares and upon the property of such banks, except local taxes on real estate.

Section 14 of Article XIII, subdivision (d), also directed the assessment of all "franchises" at their

actual cash value, in a manner to be provided by law, and the levy thereon of a State tax at a fixed rate which was also subject to legislative change by a two-thirds vote of each house.

The State tax on bank shares of stock was before the Supreme Court of California in

Bank of California vs. *Roberts*, 173 Cal. 398,

and before this court in

Bank of California vs. *Roberts*, 248 U. S. 476.

The State "franchise" tax provided for by said subdivision (d) of section 14 of Article XIII was analyzed and held to be in reality a "corporate excess" tax, not an excise, by the Supreme Court of California in

Miller and Lux vs. *Richardson*, 182 Cal. 115.

Permission to tax shares of stock in National banks upon their value exists in section 5219 of the Revised Statutes of the United States but Congress has annexed the condition that moneyed capital employed in competition with National banks must be subjected by the states to a like tax burden. Prior to 1927 the states were in doubt as to the extent to which that qualification applied, but any uncertainty was definitely dispelled in March of that year by the decisions of this court in the cases of

First National Bank vs. *City of Hartford*, 273 U. S. 548; 47 S. Ct. 462;

Georgetown National Bank vs. *McFarland*, 273 U. S. 568; 47 S. Ct. 467;

State of Minnesota vs. *First National Bank of St. Paul*, 273 U. S. 561; 47 S. Ct. 468.

In those decisions it was held that section 5219 is not directed merely at discriminatory taxation which favors a competing banking business; that competition, in the sense intended, arises not from the character of the business of those who compete, but from the manner of the employment of the capital at their command; and that the section was intended to prevent the fostering of unequal competition with the business of National banks by the aid of discriminatory taxation in favor of capital invested by institutions or individuals engaged either in similar business or in particular operations or investments like those of National banks.

Basing their attack upon the principles thus laid down by this court, scores of actions were filed in the year 1927 against the State of California by National and State banks alleging that our tax system illegally discriminated in favor of competing moneyed capital. Apparently the actions were well founded and the State was faced with the probability that it would be forced to return to the banks practically five million dollars in taxes for the years 1926 and 1927 and that the potential loss to the State would approximate twenty-two million dollars unless a change was immediately made in the tax system.

About the time those actions were filed it happened that there was in the process of organization a State

Tax Commission appointed by the Governor of California under the direction of an act of the Legislature to make a general study of the California tax situation. The emergency created by the pendency of those actions demanded the immediate attention of that body. All of the energies of that commission were rallied to meet the emergency.

After months of intensive investigation, under the guidance of an internationally recognized technical adviser, the commission recommended to the Governor that the Legislature be convened in extraordinary session to propose a constitutional amendment. A special session was called and the Legislature unanimously proposed that the State tax system be amended through the addition of section 16 to Article XIII of the Constitution. At the general election in November, 1928, the amendment was adopted.

Section 16 of Article XIII abandoned the tax on bank shares and substituted a State tax on National and State banks in an amount measured by a percentage of their net income. Permission to do so had been extended by Congress in its 1926 amendment of section 5219 R. S. The amendment provides that if banks are so taxed the net income may "include the entire net income received from all sources." *It adds the condition,* however, that the burden so imposed upon National banks shall not exceed the burden imposed by the taxing state upon other financial corporations or upon mercantile,

manufacturing and business corporations doing business within its limits.

To insure certain and complete compliance with the conditions annexed to the permission so granted by Congress, said section 16 of Article XIII substituted for the "corporate excess" tax on general corporations, a State franchise tax on all financial, mercantile, manufacturing and business corporations doing business in California, other than utilities taxed by the gross receipts method, measured in amount at 4 per cent of their net income from business done in California.

Section 16 of Article XIII of the California Constitution reads, in full, as follows:

"Notwithstanding any other provision of the constitution:

1. (a) Banks, including national banking associations, located within the limits of this state, shall annually pay to the state a tax according to or measured by their net income, which shall be, in lieu of all other taxes and licenses, state, county and municipal, upon such banks, or the shares thereof, except taxes upon their real property. The amount of the tax shall be equivalent to four per cent of their net income.

(b) The Legislature, two-thirds of all the members elected to each of the two houses voting in favor thereof, in lieu of such tax, may provide by law for any other form of taxation now or hereafter permitted by the congress of the United States respecting national banking associations; provided, that such form of taxation shall apply

to all banks located within the limits of this state.

(c) If it be finally determined that any tax levied upon or respecting any bank, national banking association, or the shares thereof, is invalid, said bank or association, or the shares thereof, shall be reassessed in conformity with any method provided by law. No claim against the state for refund or rebate of taxes paid shall be allowed without first deducting therefrom the amount of any such unpaid reassessment.

2. (a) All financial, mercantile, manufacturing and business corporations doing business within the limits of this state, subject to be taxed pursuant to subdivision (d) of section 14 of this article, in lieu of the tax thereby provided for, shall annually pay to the state for the privilege of exercising their corporate franchises within this state a tax according to or measured by their net income. The amount of such state tax shall be equivalent to four per cent of their net income. Such tax shall be subject to offset, in a manner to be prescribed by law, in the amount of personal property taxes paid by such corporations to the state or political subdivisions thereof, but the offset shall not exceed ninety per cent of such state tax. In any event, each such corporation shall pay an annual minimum tax to the state, not subject to offset, of twenty-five dollars.

(b) The Legislature, two-thirds of all the members elected to each of the two houses voting in favor thereof, may provide by law for the taxation by any other method authorized in this constitution of the corporations, or the franchises, subject to be taxed pursuant to subdivision (a)

of paragraph 2 of this section or subdivision (d) of section 14 of this article.

3. The Legislature, two-thirds of all the members elected to each of the two houses voting in favor thereof, may change by law the rates of tax, or the percentage, amount or nature of offset provided for in paragraphs 1 and 2 hereof.

4. Notes, debentures, shares of capital stock, bonds, solvent credits, deeds of trust, mortgages, and any legal or equitable interest therein, of the classes now taxable to the owner thereof and not otherwise taxed under subdivisions (a) or (b) of section 14 or under section 15 of this article, shall be declared in a manner to be prescribed by law and shall be taxed upon their actual value at the rate of three-tenths of one per cent. The Legislature, two-thirds of all the members elected to each of the two houses voting in favor thereof, may by law change the rate or rates upon any one or more of the classes of property herein enumerated, provided that no rate shall exceed four-tenths of one per cent. Said tax shall be in lieu of all other property taxes thereon, and the proceeds of said tax shall not go to the state but to such political subdivisions thereof, and in such manner, as may be provided by law.

5. The Legislature shall define "corporations" and "doing business"; shall define "net income" and may define it to be the entire net income received from all sources; shall provide for the allocation of income, for the assessment, levy and collection of the aforesaid taxes, and for reassessment in the event of the invalidity of any tax under 2 (a) or 2 (b) hereof. Said taxes shall be-

come a lien on the first Monday in March of 1929 and of each year thereafter. The Legislature shall pass laws necessary to carry out this section. The acts of the forty-eighth session of the Legislature passed pursuant to this section shall be effective immediately upon their passage."

By the terms of section 16 of Article XIII the tax upon the corporations other than banks, therein specified, is declared to be an annual tax for the privilege of exercising their corporate franchises within this State. In paragraph 5 of the section the Legislature is directed to define "net income," and is authorized to define it "to be the entire net income received from all sources." The same paragraph instructed the Legislature to enact enabling legislation, which brought into existence the Bank and Corporation Franchise Tax Act, effective March 1, 1929.

The Bank and Corporation Franchise Tax Act defined "net income" (section 7) to be the "gross income" less certain deductions. "Gross income" is defined in section 6 to include "all interest received from Federal, State, municipal or other bonds." The deductions from gross income are prescribed in section 8. The rate of the tax is fixed by section 16 of Article XIII at 4 per cent. Acting under the authority delegated to it by said section, the Legislature went beyond the offset provision fixed in the constitutional section and has provided that a corporation shall be entitled to an offset

against the State franchise tax in the amount of taxes paid locally upon its real and personal property with the qualification that the total offset shall not exceed 75 per cent of the State tax, and that in no case shall the corporation be entitled to offset more than 10 per cent of its real property taxes. By the statute the banks are given the benefit of the same offset provision except that the personal property of National and State banks is exempt from personal property taxation under the terms of section 16 of Article XIII.

The Bank and Corporation Franchise Tax Act recognizes that some corporations keep their books and accounts on a fiscal year basis and others on a calendar year basis, and therefore the "taxable year" is defined in section 11 to mean either the calendar or fiscal year, as the case may be. The tax is prospective in its operation under the terms of the act, and is administered by the Franchise Tax Commissioner for whom provision is made in section 22. Applying the statute to the case of this appellant corporation, which keeps its books on the calendar year basis, it was obliged, by reason of section 13 of the act, to report to the commissioner its "net income" during the calendar year 1928. The State tax measured by that net income, less such offsets as appellant was entitled to, represented a tax to the State by appellant for the privilege of exercising its corporate franchises within the State during the calendar year 1929.

APPELLEE'S ARGUMENT

I

The Tax in Question Is a Valid Excise

It is apparent that the fundamental issue in this case is the nature of the tax herein involved, with particular reference to whether that tax is a tax on the bonds or is a true franchise, or excise, tax.

(a) A Technical Analysis of the Tax.

In section 16, Article XIII of the California Constitution, the tax imposed upon appellant is denominated a tax for appellant's privilege of exercising its corporate franchises within this State. In making this observation we are not arguing that this characterization of the tax is of controlling importance in determining whether the tax is consistent with the Federal Constitution, but we are arguing that the circumstance has a real significance in testing the tax against other sections of the California Constitution. That designation of the tax by section 16 of Article XIII is repeated by the Legislature in section 4 of the Bank and Corporation Franchise Tax Act.

The statutory definition of "net income" is the yardstick by which appellant's State franchise tax for 1929 has been measured. A restatement, with further detail, of the processes by which the net income is calculated will demonstrate that income from bonds immune to property taxes is but incidentally related to the amount of the State franchise tax.

The taxpayer is required by the statute to report its entire gross income, including the interest received from bonds of all kinds. The taxpayer is entitled to deduct from its gross income all of the allowances prescribed in section 8 of the act which, generally stated, cover operating expense, certain taxes and licenses including Federal income tax, losses, debts, depletion, depreciation, and dividends received from income arising out of business done in California. If the difference between the gross income and the deductions represents net income from business not entirely done in California, if that difference represents income from business having its source in corporate activity by the taxpayer outside of California, then, according to section 10, there must be an apportionment or allocation of the entire net income in order that it may be determined what proportion of the entire net income represent business done or having its source in the taxpayer's corporate activity in California. Section 10 declares that the object of such apportionment is to assign to California that portion of the entire net income reasonably attributable to business done in California and to avoid subjecting the taxpayer to double taxation.

When the net income from business done in California is thus determined the amount thereof becomes the basis by which the amount of the franchise tax is measured. The 4 per cent rate is applied to the net income and against the amount thus produced

the taxpayer is entitled to the offsets above described. The remainder is the tax for which it is liable.

It is apparent, therefore, that the franchise tax is not levied by necessary intendment upon every dollar of interest and profits that a taxpayer receives from bonds exempt from property taxes. It is conceivable that conditions might exist whereby the amount of the franchise tax would not be increased by the receipt of income from such bonds. The amount of the tax, manifestly, does not vary in exact proportion to the gross income from the bonds included in the aggregate.

(b) A Corporation Franchise Tax Measured by a Percentage of Net Income is Not a Property Tax.

This court has consistently held, over a long period of years, that either the State or the Nation may legally impose a franchise tax upon corporations for the right to exercise their corporate privileges, measured in amount by a percentage of net income although a portion of the income is derived from property which in itself is nontaxable, the court stating that the distinction lies between the attempt to tax the property as such and to measure a legitimate tax upon the privileges involved in the use of such property.

Flint vs. *Stone-Tracy Co.*, 220 U. S. 107;
Maine vs. *Grand Trunk R. R. Co.*, 142 U. S. 217;
Galveston R. R. Co. vs. *Texas*, 210 U. S. 217, 226;
Bass, etc., Co. vs. *State Tax Commission*, 266 U. S. 271;

New York vs. *Jersawit*, 263 U. S. 493, 496;
Educational Films Corp. vs. *Ward*, 282 U. S. 379.

The *Flint* case involved the Federal Corporation Tax Act of 1909 which imposed a tax with respect to the carrying on or doing business by corporations, the tax to be assessed upon net income received from all sources. The report of the *Flint* case discloses that a most vigorous attack was launched against the Federal statute because of the reflection of income from nontaxable bonds in the amount of the tax; that the attack was conducted by many eminent lawyers, with an equally imposing array of counsel in defense of the statute; that there was a most thorough and exhaustive consideration of the basic point upon which this appeal is founded; and that there was an exploration into the depths of all of the decisions bearing upon the matter and handed down prior to the *Flint* decision.

The *Bass* and *Jersawit* cases involved the Corporation Franchise Tax Act of New York upon which the California act is closely patterned. They did not involve the question of including interest from nontaxables in the net income base, although the New York law provides for such inclusion, but in each case it was definitely held that the tax was *not* a tax upon income but "primarily a tax levied for the privilege of doing business in the state."

Flint vs. *Stone-Tracy Co.* is generally regarded as the leading case not only to the effect that a tax

for the privilege of exercising corporate privileges measured by a percentage of net income is not a property tax but also as authority to the effect that the inclusion of interest from nontaxables in the net income yardstick is legitimate. This decision in both aspects noted has been approved and applied as sound precedent in the following cases, which include the *Macallen* case upon which appellant places its entire reliance:

McCoach vs. *Mineville Ry. Co.*, 228 U. S. 295, 387;
Stratton's Independence Ltd. vs. *Howbert*, 231 U. S. 399, 416;
Interboro Transit Co. vs. *Sohmer*, 237 U. S. 276, 284;
Equitable Life Soc. vs. *Pennsylvania*, 238 U. S. 143, 147;
Anderson vs. *42 Broadway Co.*, 239 U. S. 69, 72;
Fidelity and Colonial Trust Co. vs. *Louisville*, 245 U. S. 54, 59;
Doyle vs. *Mitchell Co.*, 247 U. S. 179, 182;
Ray Copper Co. vs. *U. S.* 268 U. S. 373, 376;
Macallen Co. vs. *Massachusetts*, 279 U. S. 620;
Educational Films Corp. vs. *Ward*, *supra*.

(c) A Corporation Franchise Tax Measured By Dividends or Bank Deposits or Corporate Excess Is Not a Property Tax.

A group of measurement cases that preceded the *Flint* case, and influenced the decision therein rendered, will next be considered:

Society for Savings vs. *Coite*, 73 U. S. 594:

This involved a franchise tax imposed by the State of Connecticut upon savings banks equal to three-fourths of one per cent of their deposits. Securities of the United States declared by Congress to be exempt from taxation by state authority constituted a large part of the assets of the plaintiff bank, and for that reason the tax was alleged to be invalid.

It was held, however, that the tax was not upon property, but was a valid excise imposed upon the corporation as such; that it was competent for the state legislature to levy such an excise upon the privilege of corporations doing business within the state; that it was proper to determine the tax by a measure "to be ascertained in some mode by the amount of business which the corporation shall transact within a defined period"; and that the state's power "is wholly unaffected by the fact that the corporation * * * has or has not made investment in federal securities."

Provident Institution for Savings vs. *Massachusetts*, 73 U. S. 611:

In this case the court was concerned with an excise tax imposed by Massachusetts upon savings banks measured by three-fourths of 1 per cent of their average deposits. The fact that the bank had invested in substantial amounts of Federal bonds constituted the basis of the attack upon the tax.

The tax was upheld despite the fact that the funds of the bank were largely invested in Federal bonds, the court saying:

> "The tax * * * is not a tax on the capital stock or property of the company, but upon its corporate franchise, and is not therefore subject to the objection stated by counsel, because a portion of its capital stock is invested in securities of the United States."

Hamilton Co. vs. *Massachusetts,* 73 U. S. 632:

This dealt with an excise tax imposed by Massachusetts and measured in amount by one-sixth of 1 per cent of the excess of market value of the capital stock of business corporations over the value of their real estate and machinery. The company was a large owner of Federal securities which were unquestionably reflected in the value of the company's capital stock, and for this reason the legality of the tax was put in question.

The court declared that the tax was valid, saying:

> "It is quite clear that the substantial question presented for decision is the same as that determined in the case just decided (*Provident Institution* vs. *Massachusetts,* 6 Wall. 611). * * * Property taxation and excise taxation, as authorized in the constitution of the state, are perfectly distinct, and the two systems are easily distinguished from each other, if we adopt the definition of the term 'commodities' as uniformly given by the courts of the state, and as universally understood by the taxpayers and assessors."

Home Insurance Co. vs. *New York,* 134 U. S. 594:

An excise imposed by New York upon business corporations measured by the extent of the dividends paid by the corporation during the year was resisted, on constitutional grounds, because the company derived a large part of its revenue from government bonds, and these receipts were in turn reflected in the dividends paid by the company.

It was held that the tax was a valid excise and the plan of measurement a proper one, the court saying:

> "In this case we hold, as well upon general principles as upon the authority of the first two cases cited from 6th Wallace (*Society for Savings* vs. *Coite,* 6 Wall. 594; *Provident Institution* vs. *Massachusetts,* Id. 611), that the tax * * * is not a tax on the capital stock or property of the company, but upon its corporate franchise, and is not therefore subject to the objection stated by counsel, because a portion of its capital stock is invested in securities of the United States."

(d) State Inheritance Taxes Are Valid Excises Although Measured by the Value of Nontaxables.

Upon like principle, State inheritance taxes measured by methods taking into consideration the value of nontaxable bonds of the decedent have been upheld, where the issue was the inclusion or reflection of the value of the nontaxables in the basis of measurement.

Plummer vs. *Coler,* 178 U. S. 115;
Griener vs. *Llewelyn,* 258 U. S. 384;
Blodgett vs. *Silverman,* 277 U. S. 1, 12.

(e) A Corporation Franchise Tax Measured by Capital Stock Reflecting the Value of Nontaxables Is Not a Property Tax.

Similarly, it has been held that an excise on a corporation may be measured by its outstanding stock. In the cases we cite to this effect the State law did not contain a provision for excluding nontaxables or the income therefrom from the tax base, and the issue was whether the tax was an excise or a property tax.

Hump Hair Pin Co. vs. *Emmerson,* 258 U. S. 290 (Ill.);
People vs. *Latrobe,* 49 S. Ct. 377 (New York);
International Shoe Co. vs. *Shartel,* 49 S. Ct. 380 (Missouri);
Roberts vs. *Emmerson,* 46 S. Ct. 375;
Kansas City vs. *Botkin,* 240 U. S. 227;
Western Cartridge Co. vs. *Emmerson,* 50 S. Ct. 383.

From the *Roberts* case, just cited, we quote the following:

> "The tax is imposed as a franchise tax upon a *domestic* corporation doing business only within the State. Its power to issue shares of both classes is derived from the laws of Illinois. The amount which may be issued; the manner of issue; the liability of holders of these shares and all other incidents of them, are regulated by the law of that state. The tax is not a property tax imposed on shares of stock or on the assets of the corporation. It is a tax on the corporate franchise, which includes the privilege, whether exer-

eised or not, or issuing and using when issued, a particular kind of stock known as "no-par value stock." As the stock may, under the statute, be issued for as much as $100 a share, if the company so chooses, the statute fixes the maximum extent to which the privilege may be exercised as the basis for computing the tax.

Neither this privilege nor the corresponding privilege of issuing par value stock bears any necessary relation to the value of the stock or the assets of the corporation; and the tax is imposed whether or not the stock is issued and without regard to the value of the stock or of the corporate property. * * *." (Italics ours.)

(f) A Corporation Franchise Tax Measured in Part by Net Income From Interstate Commerce Is Not a Property Tax.

Also, it has been held that an excise on a corporation may legally be measured by net income derived by the corporation from business done within the taxing state even though a part of the corporate capital is used in interstate commerce or some of its income is derived therefrom. In other words, the decisions in this group hold that a tax remains an excise and does not become a tax on property merely because some of the corporate capital located outside of the taxing state contributes to the earning of the net income by which the amount of the tax is measured, or merely because some of that net income is derived from interstate transactions. The cases to this effect are

Underwood Typewriter Co. vs. *Chamberlain*, 254 U. S. 113;
Bass, etc., Co. vs. *State Tax Commission, supra*;
Alpha Portland Cement Co. vs. *Massachusetts*, 268 U. S. 203, 216;
National Leather Co. vs. *Massachusetts*, 48 Sup. Ct. 534.

Up to this point we have cited instances of taxes held to be excises, as distinguished from property taxes, in which the basis for determining the amount of the tax was net income from business done within the taxing state, savings deposits within the taxing state, corporate excess within the taxing state, and annual dividends.

We now turn to a consideration of a number of cases involving a strict property tax, where this court, and other courts, have sustained a method for treatment of nontaxables not unlike the method with which this court was concerned in the *Flint* case.

(g) A State Tax on the Operative Property of Public Utilities Fixed at a Percentage of Gross Income From All Sources, Including Nontaxables, Is a Valid Property Tax.

Eight years after the adoption of section 1¾ of Article XIII of the California Constitution, by which State and local bonds are free and exempt from taxation, the people of this State added section 14 to that article and provided for the taxation of the operative property of certain public utilities in a percentage of the gross receipts from the operation of that property. Section 14 subdivision (a)

defines the operative property of railroad companies as:

> "their franchises, roadways, roadbeds, rails, rolling stock, poles, wires, pipes, canals, conduits, rights of way and other property, or any part thereof, used exclusively in the operation of their business in this state * * *."

Subdivision (a) of section 14 prescribes a formula whereby the gross receipts are assigned to California on a mileage prorate basis in the case of interstate operation. It is to be noted that the constitutional definition of "operative property" includes, instead of excluding, all corporate privileges and franchises and all property of every kind which makes possible the conduct of the utility business and contributes to the gross earning capacity of the operative property.

That portion of section 14 taxing the operative property of railroad companies was upheld as a property tax in the cases of

San Diego, etc., Ry. Co. vs. *State Board of Equalization,* 165 Cal. 516;

Lake Tahoe Ry. & Transportation Co. vs. *Roberts,* 168 Cal. 551;

County of San Bernardino vs. *State Board of Equalization,* 172 Cal. 76;

Southern Pacific Co. vs. *Levee District No. 1,* 172 Cal. 354;

Southern Pacific Co. vs. *Richardson,* 181 Cal. 280;

Pullman Co. vs. *Richardson* and *Walker D. Hines* vs. *Richardson,* 185 Cal. 484.

That portion of section 14 taxing the operative property of telegraph and telephone companies was upheld as a property tax in the case of

San Francisco vs. *Pacific Telephone and Telegraph Co.*, 166 Cal. 244.

That portion of section 14 taxing the operative property of companies engaged in the transmission or sale of gas or electricity was upheld as a property tax in the cases of

Pacific Gas and Electric Co. vs. *Roberts*, 168 Cal. 420; and

Pacific Gas and Electric Co. vs. *Roberts*, 176 Cal. 183.

The constitutionality of section 14 of Article XIII of the California Constitution under the commerce clause and under the due process clause of the Federal Constitution was sustained by this court in

Pullman Co. vs. *Richardson*, 261 U. S. 330,

which cited approvingly:

U. S. Express Co. vs. *Minnesota*, 223 U. S. 335; and

Cudahy Packing Co. vs. *Minnesota*, 246 U. S. 450.

The two cases last cited involved the gross receipts tax on the operative property of railroad companies under the Minnesota gross receipts tax system, and in the *U. S. Express Co.* case it was expressly urged that the taxing method was violative of the Federal

Constitution. In pronouncing the method legal this court made the very significant statement that the question,

> "in principle not unlike the one here presented came before this court in *Flint* vs. *Stone-Tracy Co.*, 220 U. S. 107."

Immediately following that statement the court proceeded to discuss and approve the measurement rule of the *Flint* case with particular reference to the matter of including interest from tax-exempts in the tax base.

The principle inherent in the method of taxing the operative property of public utilities at a percentage of their gross earnings has also been upheld in the more recent case of

> *Great Northern Railway Co.* vs. *Minnesota*, 278 U. S. 503.

In the so-called King tax bill litigation in California, which involved the 1921 increase by the Legislature of the rate applicable to the gross receipts of railroad companies from 5¼ to 7 per cent, one of the two main issues was whether the California gross receipts taxing system was consistent with the Federal Constitution in that the Southern Pacific Company, one of the contesting companies, owned valuable and extensive franchises from the Federal government.

The Federal franchises there in question comprehended grants by Congress to build and operate rail

and telegraph lines between termini within the State of California and between points within and points outside of California. It was argued that those franchises are used and operated in railroad service within California; that they have a substantial value; that their value is so blended with the value of its railroad property within the State of California that it can not be segregated from the aggregate value of its California railroad property; that the State law does not provide for such segregation of value; that in its tax report the company made no segregation; that said franchises were taxed by the State under section 14, Article XIII of the State Constitution; and that such taxation, if permitted, would abridge said franchises; would impose a burden thereon, would substantially interfere with their free use and enjoyment, and consequently that such taxation is illegal.

To that argument the State replied that the right of the Southern Pacific Company to do an interstate railroad business is in reality a Federal grant or franchise that may properly be termed the major franchise; that the franchises granted by Congress, forming the basis of the litigation, were minor franchises; that if physical property employed and engaged in the exercise of rights conferred under such minor franchises was not taxable for the reasons presented by the company, such would also be the situation in regard to the major franchise; and that if the company's contention were sound there would

be no right in a state to tax the physical property of an interstate railroad, operating within the taxing state, by the gross receipts system or by any other method of property taxation.

The United States District Court, in which the litigation occurred, sustained the State's view and held that the tax was not invalid by reason of the company's ownership and use of the Federal franchises.

Atchison, etc., Ry. Co. vs. *Collins,* 294 Fed. 742;
Southern Pac. Ry. Co. vs. *Collins,* 294 Fed. 742.

An appeal was perfected to this court but was thereafter dismissed on motion of the appellant. We quote the following from the opinion of the District Court upon the contention advanced by Southern Pacific Company:

> "It contends that the tax in question imposes a burden upon these franchises, as well as other property owned by it, and that, inasmuch as the franchises are so blended with its other property that the value thereof can not be segregated or appraised, the entire tax is void, relying chiefly upon *California* vs. *Central Pacific R. R. Co.,* 127 U. S. 1, 8 Sup. Ct. 1073, 32 L. Ed. 150. If the doctrine of this case is not impliedly qualified by later decisions of the Supreme Court, its application would seem to be confined to very narrow limits (*Chicago, B. & Q. R. R. Co.* vs. *Babcock,* 204 U. S. 585, 597, 27 Sup. Ct. 326, 51 L. Ed. 636), and in principle I am unable to distinguish the case here presented from *Western Union Tel. Co.*

vs. *Taggart*, 163 U. S. 1, 16 Sup. Ct. 1054, 41 L. Ed. 49, considered together with *Central Pacific R. R. Co.* vs. *California*, 162 U. S. 91, 16 Sup. Ct. 766, 40 L. Ed. 903, and *Chicago, B. & Q. R. R. Co.* vs. *Babcock, supra*, where the taxes assailed were held to be valid. The contention will therefore be denied."

The facts in the *Taggart* case are practically identical with those pertaining to the *Southern Pacific Company* case. It was admitted in the *Taggart* case that the value of federal franchises was included in the entire value of the property taxed, but the court said, relying upon its earlier decision in

Western Union Tel. Co. vs. *Massachusetts*, 125 U. S. 530, 141 U. S. 40:

"Those decisions clearly establish that a statute of a state, requiring a telegraph company to pay a tax upon its property within the state, valued at such a proportion of the whole value of its capital stock as the length of its lines within the state bears to the length of all its lines everywhere, deducting a sum equal to the value of its real estate and machinery subject to local taxation within the state, is constitutional and valid, notwithstanding that nothing is in terms directed to be deducted from the valuation, either for the value of its franchises from the United States, or for the value of its real estate and machinery situated and taxed in other states; unless there is something more showing that the system of taxation adopted is oppressive and unconstitutional."

The California gross receipts tax system was extended in 1926 by the addition of section 15 to Article XIII of the Constitution providing for the taxation of highway transportation companies. In terms and in effect section 15 is similar to section 14 of Article XIII.

Under section 15 of Article XIII a tax was levied on an automotive stage line. It was computed at a percentage of the carrier's gross earnings including revenue derived from carrying postal matter under a contract with the Federal Government. The inclusion of that revenue in the gross receipts tax base was alleged by the taxpayer to be violative of the due process clause of the Fourteenth Amendment and an interference with the operations of the Federal Government. Both contentions were rejected by this court.

Alward vs. *Johnson*, 282 U. S. 509.

(h) A State Property Tax on Corporate Excess, Partly Located Outside the Taxing State and Employed in Interstate Commerce, Is Valid.

Subdivision (d), section 14, Article XIII of the Constitution of California provides, as already noted, for the taxation of "corporate excess" in proportion to its value. The tax so provided for has been declared to be a property tax and has been upheld in the following cases:

Miller & Lux vs. *Richardson*, 182 Cal. 115;
People vs. *Alaska Pacific S. S. Co.*, 182 Cal. 202;

Pacific Coast S. S. Co. vs. *Richardson,* 186 Cal. 70;
Utah Construction Co. vs. *Richardson,* 187 Cal. 649;
People vs. *Ford Motor Co.,* 188 Cal. 8;
Schwab vs. *Richardson,* 188 Cal. 27.

The *Schwab* case, involving the operations of Oceanic Steamship Company, was appealed to this court and the decision of the State court affirmed (263 U. S. 88). It was held that the tax was essentially a property tax and not violative of the commerce clause of the fourteenth amendment. The issue developed from the fact that a substantial part of the value of the corporate excess was located outside of California and was employed in interstate commerce. It will be shown at a subsequent point in this brief that the value of the corporate excess tax was enhanced by the taxpayer's ownership of nontaxables, which was a characteristic of the corporate excess taxing method supplanted in 1928 by the excise here under consideration.

(i) State Ad Valorem Taxes on Shares of National Bank Stock Are Legal Though the Value of Tax-Exempts Is Included in the Assessment.

In the cases about to be cited under this head it was argued by the taxpayers that *ad valorem* taxes on National bank shares of stock which they owned were violative of the Federal Constitution and an interference with the power of Congress to borrow money on the credit of the United States in that in

the valuation of the shares no deduction was made for the value of tax-exempt securities. The court held, however, that the tax was on the shares and not on the securities, and that it was a mere incident that the value of the tax-exempts contributed to the aggregate valuation to which the taxing rate was applied.

Van Allen vs. *The Assessors,* 3 Wall. 573 (cited approvingly in *Educational Films Corp.* vs. *Ward, supra*);

Home Savings Bank vs. *Des Moines,* 205 U. S. 503;

Des Moines Bank vs. *Fairweather,* 263 U. S. 103, 114.

(j) A State Tax on Income May Properly Include in the Computation the Net Income Derived From Transactions in Interstate Commerce.

There are also cases to the effect that a state net income tax does not offend the commerce clause even though a part of the taxpayer's capital is used in or some of its income is derived from interstate commerce.

U. S. Glue Co. vs. *Oak Creek,* 247 U. S. 321, 328;
Peck vs. *Lowe,* 247 U. S. 165.

(k) A State Property Tax on Insurance Companies Fixed at a Percentage of Their Gross Premiums, With no Deductions, Is Valid.

Under subdivision (b), section 14, Article XIII of the California Constitution every insurance company doing business in this State pays, and since

1910 has paid, an annual tax on the amount of the gross premiums upon its business done in this State. The rate was originally 1.5 per cent but is now fixed at 2.6 per cent by section 3664b of the Political Code.

This tax is in lieu of all taxes and license, State, county and municipal, upon the property of such companies except county and municipal taxes on real estate. There is no provision in the Constitution or in the enabling acts for the exclusion from gross premiums of any amount estimated to be the result of the ownership by an insurance company of tax-exempt bonds. The tax has, however, been upheld as a property tax in the cases of

Hartford vs. *Jordan,* 168 Cal. 270;
Hughes vs. *Los Angeles,* 168 Cal. 764;
Northwestern Mutual, etc., Co. vs. *Roberts,* 177 Cal. 540;
Bankers Life, etc., Co. vs. *Richardson,* 192 Cal. 113.

Applying the legal principles laid down in the tax cases above cited to the California franchise tax it is evident that the California franchise tax is not a property tax but a privilege tax; that the relation of income from nontaxables to the amount of the tax is incidental; that there is no violation of the fourteenth amendment or of the commerce clause, and that the provisions in the California and Federal constitutions prohibiting the impairment of obligations of contracts are not offended.

II

SECTION 1¾ OF ARTICLE XIII OF THE CALIFORNIA CONSTITUTION IS AN EXEMPTION FROM PROPERTY TAXES ONLY; IT DOES NOT EXPRESS AN OBLIGATION TO EXEMPT THE BONDS IN QUESTION FROM TAXATION UNDER THE STATE BANK AND CORPORATION FRANCHISE TAX ACT.

Section 1 of Article XIII of the Constitution of California, as adopted in 1879, provided that

> "All property in the State, not exempt under the laws of the United States, shall be taxed in proportion to its value to be ascertained as provided by law."

An exemption was made in favor of such property

> "as may belong to the United States, this State or to any county or municipal corporation within this State."

That section was amended in 1894 to exempt free public libraries and free museums from taxation.

In that form, section 1 of Article XIII was construed by our State court to require that *all* property be taxed according to its value, except property expressly exempted. This necessarily included as taxable property corporate excess reflecting the value of bonds of all kinds, and shares of stock comprehending the value contributed to the shares by the corporate ownership of bonds of all kinds and by their increment.

Burke vs. *Badlam*, 57 Cal. 594;
San Jose Gas Co. vs. *January*, 57 Cal. 614;
Spring Valley vs. *Schottler*, 62 Cal. 69;
McHenry vs. *Downer*, 116 Cal. 20;
Bank of California vs. *San Francisco*, 142 Cal. 276.

In 1902, section 1¾ was added to Article XIII of the California Constitution providing that:

> "All bonds hereafter issued by the State of California, or by any county, city and county, municipal corporation, or district within said State, shall be free and exempt from taxation."

Prior to 1902 and at the time of the adoption of section 1¾ of Article XIII, the only State tax in existence under the law of California was a tax on property according to its value. There was no State corporation excise tax or the equivalent thereof. Section 1¾ of Article XIII, therefore, must have been adopted in the light of that situation and the only reasonable interpretation of its exempting terms is that it freed State, county and municipal bonds from the payment of property taxes. Further proof of the necessarily limited scope of section 1¾ of Article XIII is afforded by the decisions of the Supreme Court of California subsequent to 1902, from which it appears that the taxing officials, corporation tax payers and the court recognized that the exempting amendment of 1902 affected property taxes only. The proof of this lies in the fact that corporate excess, or the difference between the market value of

corporate shares and the value of the corporation's tangible property, was taxed for State purposes under the authorization of that portion of section 1 of Article XIII requiring that all "property" be taxed and defining "property" to include, among other things, "franchises."

The decisions in the *Burke, January, Spring Valley* and *Bank of California* cases, all rendered prior to the exempting amendment of 1902, were reaffirmed and followed in the case of

Crocker vs. *Scott,* 149 Cal. 575,

which was decided in 1906, and in 1916, in the case of

Bank of California vs. *Roberts,* 173 Cal. 398, 248 U. S. 476.

We quote the following from the *Crocker* case:

> "It appears too clear for question that such difference between the market value of the shares of stock and the value of the tangible property is necessarily the aggregate cash value of such intangible property as under our system must be held to belong to the corporation, call it franchise, good will, or dividend or profit-earning power, or what you please. Whatever it is, our laws positively require it to be assessed by the assessing officers to the corporation at its full cash value, precisely as all other property is required to be assessed at its full cash value."

For twenty-three years prior to 1902 and from 1902 to and including 1910, notwithstanding the exemption of bonds from property taxes in 1902, the

value of all bonds was reflected in and contributed to the amount of *ad valorem* taxes levied by the State during that entire period.

In 1910 the California Constitution was amended by adding section 14 to Article XIII. It provided for the taxation of the corporate excess of corporations generally under the misnomer "franchises" appearing in subdivision (d) of that section, and for the inclusion of "franchises" within the definition of operative property of public utilities subjected by that section to the gross receipts taxing method.

The report of the California Tax Commission of 1906 and its explanation of the term "franchises" appearing in subdivision (d), section 14, Article XIII of the Constitution, was considered by our State court in the case of

Miller & Lux vs. *Richardson,* 182 Cal. 115,

wherein it was said of the meaning of the term "franchise":

> "The theory is that the value of the company's outstanding stocks and bonds represents the value of its total assets, so that the difference between this total and the value of the company's physical properties represents the value of the company's intangible assets, and an assessment of the corporate excess, that is, of this difference, is an assessment of all the company's so-called intangibles."

"Corporate excess," the property of general corporations, made taxable by the State under subdivision (d), section 14, Article XIII, of the California Constitution, means, therefore, the difference between the aggregate value of the shares of stock, and outstanding bonds, if any, and the value of a corporation's tangible property. The proper steps in the ascertainment of the value of corporate excess, according to the *Miller and Lux* decision, are:

(1) The valuation of the corporate shares, and outstanding bonds, if any;

(2) The valuation of the corporation's tangible property, and

(3) The deduction of two from one, the difference representing the corporate excess or "franchise" to which the statutory rate or tax percentage was to be applied.

The method explained and approved in the *Miller and Lux* case does not provide for or permit of any deduction from the aggregate value of corporate shares and outstanding bonds, other than the deduction of the aggregate value of the corporation's tangible property.

Every portion of corporate capital, every piece of property, whether taxable or nontaxable, contributes to the value of corporate shares and corporate bonds. The ownership by a corporation of nontaxable bonds and their investment and manipulation by a corporation necessarily are reflected in the value of the corporate shares and bonds. It is evident, therefore,

that the value of the corporate excess was increased through the existence of nontaxable bonds and other forms of tax-exempt property.

The market value of stocks and bonds is influenced by the extent and nature of a corporation's investment in securities and by the amount of the accruals therefrom. All property owned by a corporation, including its nontaxables, produces the corporate earnings, and therefore the ascertainment of the value of the corporation's stocks and outstanding bonds by capitalization of the corporate net earnings is a method whereby the corporation's tax-exempt bonds, and the interest therefrom, affect in some degree the value of the corporate excess.

It is also of significance to note that from 1915 to 1928 there was in effect in this State a corporation license tax (Chapter 190, Statutes of 1915), which prescribed an annual charge upon corporations, other than those protected by the lieu provisions in section 14 of Article XIII, of a license tax measured by the amount of authorized capital stock, with no deductions on account of the ownership of nontaxables. This statute was adjudged invalid in its application to foreign corporations in

Perkins Manufacturing Co. vs. *Jordan,* 200 Cal. 667,

but it was valid in its application to domestic corporations according to

Roberts vs. *Emmerson, supra.*

The license tax features of this act were repealed in 1927 (Statutes of 1927, p. 396), the repeal being effective as of January 1, 1928. It is a matter of official history that the reason for this repeal was the increase of the corporate excess or franchise tax rate, in 1927, from 1.6 per cent to 1.8 per cent.

This was the general situation in 1928 when the proposal was made to add section 16 to Article XIII of the Constitution.

The addition of section 16 to Article XIII of the California Constitution in November, 1928, did not, therefore, mark the beginning of a new tax policy with respect to the treatment of interest from bonds exempt from property taxes under the amendment of 1902. The amendment of 1928 represents a *continuation* of the original policy in that regard.

Long before the adoption of the amendment of 1902, and ever since that time, the Federal Government and the states, with the approval of State and Federal courts, including our highest court, proceeded, in the structure of their tax systems, on the theory that income from bonds free from property taxes could be included in the measure of a franchise or excise tax on corporations. Presumably, the people of this State were aware of that situation in amending the State Constitution in 1902, and had they desired to extend the scope of the amendment to force the abandonment of that tax policy in this State, there would appear in the amendment some language reasonably indicating, or reasonably sus-

ceptible of the interpretation, that such was the intent of the people. The language of the amendment is conclusive that such was not the intent of the people.

Were there any doubt concerning the meaning of the amendment, that doubt, under the universal rule, would be resolved against the taxpayer, for the rule of strict construction prevails in the matter of exemptions from taxation.

Seton Hall College vs. *South Orange,* 242 U. S. 100;
Cleveland Electric Railway Co. vs. *Cleveland,* 204 U. S. 116;
Detroit United R. Co. vs. *Detroit,* 229 U. S. 44;
Milwaukee, etc., Ry Co. vs. *Rd. Com.,* 239 U. S. 174.
Vol. 24, Cal. Juris, "Taxation," par. 73, p. 89;
City of Pasadena vs. *Los Angeles,* 182 Cal. 171;
State Land Settlement Board vs. *Henderson,* 197 Cal. 470.

In the Milwaukee Ry. Co. case this court said that the surrender of a sovereign right must be evidenced by "terms so clear and unequivocal as to permit of no doubt as to their proper construction."

This court also said in the Seton Hall case:

"As the power to tax is an exercise of the sovereign authority of the state, essential to its existence, the fact of its surrender in favor of a corporation or an individual must be shown in language which can not be otherwise reasonably construed, and all doubts which arise as to the

intent to make such contract are to be resolved in favor of the state."

It is manifest, therefore, that the obligation of the State, under the amendment of 1902, was no more than that the bonds themselves were exempt from direct property tax levy, the State reserving to itself among other things the right in the future to declare that the profits or income from such bonds should become the measure of a tax to be levied on corporations for the privilege of exercising corporate functions within the State.

The buyers of bonds subsequent to 1902 had no reason whatever to assume that the obligation of the State in respect to the exempt feature of the bonds was to be extended to a degree never contemplated by the State itself, or that there would be read into the State's obligation or contract a provision contrary to the law existing at the time the obligation came into existence and in derogation of the State's power of imposing franchise taxes upon corporations for the privilege of doing business and exercising corporate functions within the State. To hold otherwise would clearly be to accord the buyers of bonds after the adoption of section 1¾ an advantage and a privilege which they had no right to anticipate or to believe would ever be accorded them.

Therefore, we submit that the language of section 1¾ of Article XIII of the California Constitution does not express or comprehend an obligation to exempt the income from the municipal bonds here in

question from inclusion in the tax base for the purpose of corporate franchise taxation under the Bank and Corporation Franchise Tax Act of 1929 and that, in consequence, no contract obligation of the State has been impaired.

We appreciate that this court has the power to decide for itself whether there is a contract and, if there is, the extent of its binding obligations, but in exercising that power and also in considering whether that power shall be exercised this court has repeatedly declared its desire to lean toward an agreement with the views expressed by the State court of last resort.

The exact and express requirements of the language used, construed *strictissimi juris* must be the limit of construction; no presumption in favor of grants of exclusive franchise or immunity from government control is indulged; the presumption is against the intent to grant; privilege can not arise from mere implication or inference; and doubts are resolved against claims of privilege.

Ford vs. *Delta Land Co.*, 164 U. S. 666;
Great Northern R. Co. vs. *Minnesota*, 216 U. S. 206;
Metropolitan St. R. Co. vs. *Tax Com.*, 199 U. S. 1;
Tennessee vs. *Whitworth*, 117 U. S. 139;
Louisiana R. Co. vs. *Behrman*, 235 U. S. 164;
J. W. Perry Co. vs. *Norfolk*, 220 U. S. 472.

In view of the absence of any clear intention in section 13 to exempt from the kind of a tax that is

set up in the Bank and Corporation Franchise Tax Act, we feel justified in assuming that this court will be inclined to accept and agree with the construction placed upon that section by our highest State court in the case at bar.

Georgia Ry. & Power Co. vs. *Decatur,* 262 U. S. 432;
Milwaukee, etc., Ry Co. vs. *Rd., supra;*
Home Tel. Co. vs. *Los Angeles,* 211 U. S. 265;
Waggoner vs. *Flack,* 188 U. S. 595.

The form of tax which this appeal presents for consideration is, relatively speaking, a new development. California could not have had it in mind as early as 1902 for at that time no such tax had been devised. Therefore, appellant is in a position where it is arguing that section 1¾ of Article XIII of the California Constitution must be read to include not only that type of tax which existed in 1902 in California—a pure property tax—but also to cover such forms of taxes as might thereafter be conceived. Stating it otherwise, appellant is maintaining that the exempting language was designed to affect not only the obligation of immunity from an existing property tax, but also immunity from contingent or speculative obligations from taxes that did not exist and were not even contemplated. This position is not maintainable under the declaration of this court,

construing section 10 of Article I of the Federal Constitution, in

Ochiltree vs. *Iowa Ry. Co.*, 21 Wall. 249,

from which we quote as follows:

> "* * * The obligation of contract within the meaning of the Constitution is a valid, subsisting obligation, not a contingent or speculative one."

III

ASSUMING, WITHOUT CONCEDING, THAT THE LANGUAGE OF SECTION 1¾ OF ARTICLE XIII OF THE CONSTITUTION OF CALIFORNIA, ADOPTED IN 1902, COMPREHENDED AN EXEMPTION FROM THAT KIND OF A TAX PROVIDED FOR IN SAID BANK AND CORPORATION FRANCHISE TAX ACT, THAT EXEMPTION WAS WITHDRAWN AND ELIMINATED BY SUBSEQUENT CHANGES IN THE CALIFORNIA CONSTITUTION.

Prior to the constitutional amendment of 1902 under which appellant is here claiming tax exemption California was committed by the terms of its Constitution (section 1 of Article XIII) not only to the *ad valorem* system of taxation, but to the requirement of uniformity in tax treatment under that method.

In 1910 that rigidity was broken by an amendment to section 1 of Article XIII to the effect that all property should be taxed in proportion to its value

"except as otherwise in this Constitution provided," and by the addition to Article XIII, consistently with the quoted language introduced into section 1 of that article, of a new section numbered section 14. Assuming that section 1¾ of Article XIII was intended, when adopted, to include within its reach those forms of taxes, other than strictly property taxes, where the amount of the imposition was affected in any degree by the taxpayer's ownership of bonds immune from direct taxation or by the profits or interest accruals from such bonds, the necessary effect of section 14 of Article XIII was to curtail such intendment of section 1¾ and to limit its effect to property taxes only.

Such was the necessary effect of section 14 upon section 1¾ of Article XIII in view of the provisions of section 14 taxing the operative property of utilities on their *gross* receipts, insurance companies upon their *gross* premiums, general corporations upon their corporate excess, and State and National banks upon the value of their shares of capital stock. The ownership by those taxpayers of bonds exempt from direct property taxes was, as hereinabove demonstrated, a contributing factor, to some degree, in the amount of the taxes paid to the State by all of those taxpayers.

If there were any doubt concerning the alleged effect of the amendment of 1910 to Article XIII of the California Constitution all such doubt was definitely dispelled by the amendment of 1928 and the

enabling legislation enacted in conformity therewith. Section 14 was thereby changed, as already noted, to eliminate the property tax on State and National bank shares of capital stock and to eliminate the corporate excess tax, also a property tax, and to substitute in lieu thereof, a pure franchise or excise tax by which all banks and all corporations other than utilities and insurance companies, were required to pay to the State a tax, for the privilege of operating within the State, measured in amount at the rate of 4 per cent of their net income from all sources arising out of business done in California.

We do not concede that section 1¼ of Article XIII was ever intended to exempt bonds from any tax other than the direct, old-fashioned property tax, nor do we concede that section 16 of Article XIII or the Bank and Corporation Franchise Tax Act enacted under the permission and direction of section 16, were intended to strike at interest from bonds exempt from the imposition of property taxes under section 1¼ of Article XIII, but upon the assumption that section 1¼ had a wider range than that which we attribute to it, it is obvious that the superimposition of sections 14 and 16 of Article XIII upon section 1¼ of that article restricts the exemption of section 1¼ to property taxes only.

It can not be disputed that a state has the right to change its tax policy or any policy reflected in its legislation. To assert that a policy, once adopted, becomes immutable is to assert that imperfection

and errors in legislation become constitutional rights." Such an assertion would be "a narrow conception of sovereignty." A state is free to forsake any policy after its experience has proved that the policy is injudicious and should be abandoned. "An exercise of public policy can not be resisted because of conduct or contracts done or made upon the faith of former exercises of it upon the ground that its later exercises deprive of property or invalidate those contracts."

Thornton vs. *Duffy*, 254 U. S. 361 (369);
Ochiltree vs. *Iowa Ry. Co.*, 21 Wall. 249, 253.

IV.

THE CASE OF MACALLEN VS. MASSACHUSETTS IS NOT CONCLUSIVE OR CONTROLLING

It is our contention that the cases cited under heading I of this brief establish the correctness of the judgment herein appealed from, and that there is nothing in *Macallen* vs. *Massachusetts*, *supra*, upon which decision appellant places its entire reliance, to demand a reversal of that judgment.

(a) Analysis of Macallen Decision.

Macallen vs. *Massachusetts* involved the Corporate Franchise Tax Act of Massachusetts. The statute made the amount of the tax dependent upon a percentage of the corporate excess and upon a percentage of corporate net income derived from business carried on within the State. We are here concerned with the latter feature only.

The term "net income" as defined in the Massachusetts act, prior to its amendment in 1925, *expressly excluded* interest from nontaxable bonds. In 1925 the act was amended, and concededly the sole purpose and effect of the amendment was to carry out the recommendation of the Massachusetts Tax Commission that interest from all nontaxable bonds be included in the "net income" which should serve as the base in the calculation of a portion of the tax.

Prior to 1925, income from nontaxable securities was not included or reflected *in any tax base* for the purpose of assessing franchise taxes against corporations, and prior to that year, the income from Federal, State and local bonds, as well as the bonds themselves, was exempt from taxation in Massachusetts by statutory provision.

The report of the Massachusetts Tax Commission recommending the amendment of 1925 frankly stated that *the purpose of the proposal* was to include in the tax base the income from tax exempts which theretofore had been expressly excluded. It also said:

> "Business corporations held tax-exempt securities generally not because they fit into the purpose of their organization, but for the bearing they may have upon tax payments."

This court deemed itself confronted with:

> "A distinct change of policy on the part of the Commonwealth, adopted, as though it had been

> so declared in precise words, for the general purpose of subjecting such securities *pro tanto* to the burden of the tax."

For confirmation of its view in that regard this court referred to the Tax Commission's Report and said of it:

> "The effect of the report is that nontaxable bonds nevertheless should be subjected to the burden of the tax; and, since that could not be imposed directly, the clear intimation is that it be imposed indirectly through the medium of the so-called 'excise'."

With this situation before it this court concluded that the history, form and purpose of the amendment of 1925, together with its surrounding circumstances were such as to *compel* the court to hold that the Commonwealth was in fact and in reality aiming at and seeking to burden a nontaxable subject in computing part of the tax payable by Macallen Company by net income which included income from tax-exempt bonds owned by the company.

Having held that the tax was *upon the income* in question it followed that the tax was upon nontaxable property. Having concluded that the levy in controversy was a *property tax upon nontaxable property* this court necessarily held that there was a direct burden upon instrumentalities employed by the Federal Government in the exercise of its constitutional power to borrow money on the credit of the United States.

The other necessary corollary of this court's conclusion that the tax was cast *upon nontaxable property* was that the Massachusetts statute violated those acts of Congress declaring the Federal securities to be nontaxable, and violated, as to the local bonds, provisions in the State and Federal Constitutions prohibiting the impairment of the obligation of contracts.

The decision in *Flint* vs. *Stone-Tracy Co., supra,* was the cornerstone in the defense of the Massachusetts statute. Although the decision was adverse to the commonwealth, it is obvious that the refusal of this court to decide the case upon the authority of the *Flint* decision was due to the circumstances, above detailed, leading to the enactment of the amendment of 1925. This court did not repudiate the doctrine or the principle in *Flint* vs. *Stone-Tracy Co.,* nor did it expressly or impliedly narrow or qualify the same. The court did refer to the *Flint* case as "the extreme example" of those decisions sustaining the legality of taxes imposed upon the exercise of corporate privileges measured by income including income from nontaxable property, but, nevertheless, there appears to be no recession from the position taken by this court in the *Flint* case. Further, this court cited, without a word of disapproval or limitation, its former decisions in the *Home Insurance Co., Society for Savings,* and *Provident Institution* cases, *supra.*

The explanation of *Flint* vs. *Stone-Tracy* discloses the reason for the reversal of the decision of the Massachusetts court. The relation of interest from nontaxables to a state-taxing statute which imposes a charge upon corporations for the privilege of exercising their franchises in the taxing state and measures that charge according to the net income derived from business done within the taxing state must be "fortuitous" and "incidental." Because of the circumstances peculiar to the enactment of the 1925 tax amendment by the Massachusetts Legislature, this court felt compelled to hold that Massachusetts was not therein dealing fortuitously or incidentally with interest from nontaxables but was dealing with them deliberately, *dealing with them alone,* and attempting to do that which it deemed itself powerless to do otherwise and had not theretofore done, directly or indirectly, in taxing corporations.

This court was faced, it believed, not only with a radical change of policy on the part of Massachusetts but with evidence (in the Tax Commission Report), of a single purpose by the State to subject the securities *"pro tanto"* to the burden of the tax.

Appellant's observation that a rehearing was denied by this court in the *Macallen* case, despite the efforts of legal representatives of a number of states, "including California" is perhaps intended to convey the impression that California presented *its* case to this court and that the denial of the rehearing is an indication that California stands in the same

position as Massachusetts. Whatever is appellant's purpose in this connection, the fact is that when California joined with other states, as friends of the court, in requesting that the *Macallen* case be reheard, its interest was that the integrity of the doctrine of *Flint* vs. *Stone-Tracy* be preserved intact.

In participating in the *Macallen* case California explained why it was interested in the case; admitted that California relied upon the *Flint* case in adopting section 16 of Article XIII of its Constitution, and observed that the Congress, the State of New York, the American Bankers' Association and the National Tax Association all have relied upon the *Flint* case, and that presumably Massachusetts relied upon the *Flint* case in making the franchise tax change of 1925.

The essence of California's brief in the *Macallen* case is expressed in the following quotation therefrom:

> "If the opinion already rendered herein stands as the law of the case, and is intended to repudiate the declaration in the *Flint* case with respect to the treatment of interest from tax-exempt securities in calculating the amount of a corporate franchise tax, then California is vitally affected."

California did not assert or even suggest that the *Macallen* decision, if allowed to stand, would establish the invalidity of the California act. This court doubtless concluded that its opinion was sufficiently clear to disclose that the court did not intend to

repudiate the doctrine of the *Flint* case and that the decision was not intended to go beyond the unique circumstances involved in the *Macallen* case.

(b) California's Tax Policy in Its Treatment of Tax-Exempts and Its Purpose in Enacting the Legislation Here in Question.

(1) California's Policy Toward Corporations Between 1879 and November, 1928.

In order not unduly to prolong this brief we invite the attention of the court, at this point, to the tax situation of corporations in California between the years 1879 and 1902, and between the year 1902 and the end of 1928, which we have discussed under our heading II.

Summarizing that discussion, it is there established that for practically fifty years preceding the effective adoption of section 16 of Article XIII of the California Constitution there existed in California a system of State taxation of property whereby every corporation, whether a public utility, a bank, or a general business corporation, paid to the State an annual tax to the amount of which there was an indirect contribution resulting from the ownership by the corporation of Federal, State and municipal bonds immune from direct taxation, as well as from the ownership of all other kinds of bonds and every element of value comprehended in corporate capital.

The decisions of the Supreme Court of California disclose that the court experienced no difficulty in determining the State's tax policy toward corporations during that fifty-year period. The court found that language to be clear and unequivocal. (Only in a case where the language of an enactment is ambiguous will courts consider and be influenced by administrative interpretation as explained by an administrative officer or board.)

These statements are not mere theory but are based upon uniform, consistent administration of the State property tax on corporations during that fifty-year period, and upon decisions we have cited herein involving various features of that system.

(2) The Opinion of the State Board of Equalization in the Vortox Case.

It would be futile for appellant to challenge any of those decisions and appellant does not undertake to do so. Against the clear holding of those decisions appellant urges upon this court the opinion of the State Board of Equalization of California, an administrative body, claiming that it overcomes that which appellant presumably anticipated we would say of California's tax policy between 1879 and 1928.

Assuming that the opinion of the State Board of Equalization, appended to appellant's brief, is entitled to any consideration, the opinion does not express the view that interest accruing upon bonds exempt from property taxes is not reflected in the

amount of State tax payable by a corporation, such as appellant, prior to the adoption in 1928 of section 16, Article XIII of the California Constitution, and appellant does not argue that the opinion so states.

That opinion not only fails to set forth the history of the Bank and Corporation Franchise Tax Act comprehensively but fails accurately to relate the history of the statute. It reveals a misconception of the corporate excess, or "franchise," tax which has been supplanted by the excise provided for in paragraph 2a of section 16 of Article XIII of the Constitution.

Particularly, the opinion states that the practice of the State Board of Equalization, the body charged by law with the administration of the corporate excess tax, was to exclude the value of all tax-exempt property in the calculation of the corporate excess tax.

The California court squarely held in *Miller & Lux* vs. *Richardson, supra,* that by "corporate excess" is meant the difference *between* the aggregate value of the shares of stock, and outstanding bonds if any, and the value of the corporation's tangible property. In that case the court definitely held that the proper steps in the ascertainment of the value of corporate excess are (1) the valuation of the corporate shares, and outstanding bonds if any, (2) the valuation of the corporation's tangible property, and (3) the deduction of (2) from (1), the difference representing the corporate excess or

"franchise" to which the statutory rate was to be applied. An apportionment or allocation of the corporate excess, to determine the value of the aggregate corporate excess situated within California, was necessary in a case where the corporation did business outside of California or engaged in interstate commerce.

People vs. *Ford Motor Co., supra;*
Schwab vs. *Richardson, supra.*

Notwithstanding the explicit exposition of the corporate excess tax by the California court, the opinion of the State Board of Equalization in the *Vortox* case declares that the value of tax-exempt property of corporations was not reflected in the value of corporate excess as ascertained by that board. Therein it is expressly stated that the corporate excess law "did not contemplate that the franchise value of corporations would be increased through their ownership of exempt property."

Regardless of the form of report of a taxpayer subject to the old corporate excess tax, and regardless of the data so reported, there was but one course for the State Board of Equalization to pursue in the assessment and levy of the corporate excess tax. Corporate excess was the equivalent of "franchise," in the opinion of the court in *Miller & Lux* vs. *Richardson, supra,* and the method therein pointed out for ascertaining the value of corporate excess does not permit of *any* deduction from the aggregate value of

the corporate shares and outstanding bonds other than the deduction of the aggregate value of the tangible property.

Assuming that appellant had been subject during the tax year here in question to the old corporate excess tax law instead of to the Bank and Corporation Franchise Tax Act, which superseded it, the procedure which would necessarily have been followed by the State Board of Equalization in arriving at the value of appellant's corporate excess would have been as follows: First the board would have placed a value upon appellant's shares of stock and upon any bonds of its own issue that may have been outstanding. In making that appraisal the board would have been obliged to take into consideration all assets of the corporation, including nontaxable property. The next step would have been to value all tangible property of the corporation and if that value was less than the value found in the first step of the process, to have then subtracted the value of the tangible property from the value of the stock and bonds. The difference between those two values would have been the corporate excess and to the amount of that corporate excess, without any further deduction, the statutory rate or taxing percentage would have been applied and the result of that computation would have produced the amount of tax payable by the corporation.

Thus it is apparent that such contribution as tax-exempt bonds and their incidence made to the value

of the corporation's shares and bonds of its own issue was not entirely eliminated by the mere deduction of the value of the corporation's tangible property.

The opinion of the State Board of Equalization does not dispute that the administration of the corporate excess tax was other than that which the decisions established it to be, but that opinion does indicate a misapprehension and lack of understanding of the position taken by the Franchise Tax Commissioner in applying the terms of the Bank and Corporation Franchise Tax Act to Vortox Manufacturing Company.

(3) The Reasons for the Constitutional Amendment of 1928 and for the Enactment in 1929 of the Bank and Corporation Franchise Tax Act.

The California Tax Commission of 1927 was created for the sole purpose, expressed in the act establishing the Commission (Chapter 455, Statutes of California for 1927; p. III of Final Report of the Commission, filed herein by appellant), of investigating the system of revenue and taxation in force in California and specially to report upon the matter of the relative burden of taxes borne by property under the existing State and local systems.

It merely *happened* that the Commission was available for action when the emergency arose in California in 1927 whereby it appeared that the State's tax on all banks was doubtless invalid and that the State was faced with a potential loss of $22,000,000 within a period of five years, or with the alternative

of permitting banks to go untaxed, if steps were not immediately taken to correct the situation.

Appellant has seized upon fragments of the reports of the Commission and has sought to paint to this court a picture of a deliberate movement by the State, commencing with over a year of painstaking investigation by a carefully and expensively assembled tax staff, followed by a special report of that staff and that Commission in August, 1928, and culminating in a call by the Governor for the convening of the State Legislature in extraordinary session, in the proposal of a constitutional amendment at that session and in the submission of that proposal to the people of the State and in their ratification of it at the general State election in November, 1928, every step of which, according to appellant, had as its ultimate objective the setting up of a tax scheme for the taxation of tax-exempt bonds owned by banks and commercial corporations. The bare description of appellant's picture of the situation refutes the existence of any such State program. For a State to employ such extraordinary measures for the accomplishment of such a minor result is so unreasonable, and so lacking in intelligence, that it is incredible that this court will seriously regard appellant's insistence that California's "major purpose" was to subject interest from tax-exempt bonds to the treatment here complained of.

The method pursued by the State of California differs so sharply from the course taken by the State

of Massachusetts that the inapplicability of the *Macallen* decision to the case at bar seems patent. California had as its objective the duty and purpose of remedying a vital defect in its State tax system, which, from the standpoint of a fair distribution of tax burden, as well as from the standpoint of the integrity of the State's revenue, demanded correction. That defect did not involve in any sense, or in any degree, the matter of tax treatment of so-called tax-exempts. The proof positive of this statement is to be found in the very letter of section 16 of Article XIII of the California Constitution.

Should this court, nevertheless, deem it necessary to inquire into the official background of that provision of the Constitution, there also will be found equally conclusive proof that California did not amend its Constitution, following a summary call of its Legislature, merely to substitute for a system where tax exempts indirectly figured in the amount of general corporation taxes another plan of taxation whereby interest from tax-exempt bonds would be reflected in the amount of the taxes payable to the State by general corporations. The duty which the State owed to itself and to all of the taxpayers of the State could not have been performed, and the fundamental defect in the State tax structure could not have been remedied by a course calculated only to effect such a substitution of method.

The Constitution of California had to be amended to remove the exemption of mortgages from taxation

and to eliminate or extend the provision in section 1 of Article XIII for the deduction from credits of debts due to bona fide residents of this State, which would have enabled the State to retain its tax on the shares of National and State banks, or the State had to abandon the share tax on banks and move to some of the other methods authorized by section 5219 R. S.

The special report of the California Tax Commission showed that National and State banks were grossly overtaxed by the then existing system of taxing their shares of stock. Expressing their tax burden in terms of percentage of net income, their tax rate was 11.8 per cent as compared to an average tax rate borne by general corporations of 4.4 per cent when translated into terms of percentage of net income (p. 270–1, Final Report of Commission).

The report found that if National and State banks were moved to the fourth method permitted by the act of Congress and a 4 per cent rate applied, their tax burden would be reduced about sixty per cent, and they would thereby be in a much preferred tax situation as compared with general corporations.

The discussion on pages 270 to 277 of the Final Report shows the interest of the commission not only in having the State system placed upon a clearly legal basis, but in having the State adopt a plan which would equalize, as far as possible, the tax burden and remove the gross disparities then existing not only between banks on the one hand and general

corporations on the other, but within that great group of general corporations then subject to the corporate excess tax.

Had the commission recommended, and had the State adopted, the second method sanctioned by section 5219 R. S., the amount of revenue collectible from National and State banks would have been negligible, and from a situation of extreme discrimination against the banks the State would have moved into a situation of extreme discrimination in favor of the banks and against general corporations.

Had the commission recommended, and had the State adopted the third method offered to the states by the Federal act it would have been necessary for the State to enact an income tax act. Such a move would have required a radical change in the entire tax structure of the State which, since 1910, has involved a separation of sources of taxation as between the State and lesser political subdivisions, and it would have had the further result of increasing the disparity of the respective State tax burdens of banks and general corporations. The State, as the commission's report, the Governor's communications to the legislators, and the official explanation of the proposed constitutional amendment of 1928 to the people of the State disclose, was not interested in obtaining *more tax revenue* than had been theretofore yielded by its tax system. It was interested only in maintaining the integrity of its tax revenues by the necessary major changes in its tax system,

and in the making of those changes it was desirous, having at least a limited opportunity at hand created by need for major revision, of equalizing the tax burden among corporations and as between banks and corporations of producing a fairer spread of the tax load. More revenue at the moment or in the years immediately ahead did not concern the State of California, which in 1928 had a surplus of over $20,000,000 and in 1929, before the tax change of 1928 had been put into effect, had a surplus of approximately $30,000,000 (p. 118 Biennial Report of the State Controller of California, 1929–30).

It can not reasonably be contended that California abandoned the share tax on banks in order to set up a franchise tax system whereby interest from tax exempts would be included in the tax base. The only logical and fair explanation of why the State moved off of the bank-share taxing method is because it recognized the soundness and the popularity of the exemption of mortgages from taxation, and of a low rate of taxation on intangibles such as stocks and bonds and solvent credits.

Viewing the matter fairly and in its larger aspects, as appellant seemingly has not done, it can not reasonably be contended that the State failed to change from the bank-share tax method to the method of taxing dividends from bank shares merely to accomplish the inclusion of interest of tax exempts in the tax base under a franchise tax plan. The only logical and fair explanation of the State's decision not

to adopt the second method authorized by section 5219 R. S., is because the adoption of that method of taxing National and State banks would have meant virtual tax immunity for the banks, a situation which the State did not regard as desirable from any standpoint.

Nor can it reasonably be contended that the State failed to move banks from the share-tax method to a method whereby they were taxed *on* their net income merely for the purpose of including interest from tax exempts in the base of a tax which is not a tax on income but a tax for the privilege of exercising corporate privileges measured in amount by net income arising from corporate business done within the taxing State.

The only logical and fair explanation of the decision by the State to adopt the fourth method permitted by section 5219 R. S. instead of the third method therein held out to the states is because California had no income tax, would have had to enact an income tax, would have encountered widespread opposition to an income tax proposal and possibly would not have succeeded in enacting it into law. Ever since 1879 the Constitution of California has authorized the Legislature to provide for an income tax of any kind, but that delegated authority has never been exercised. (Section 11, Article XIII.) It was imperative that the commission recommend and that the State adopt a plan which would be legal and a plan which the voters of the State and the members

of the State Legislature would approve. There was no time for experiment or for delay, and the State was in no position to take any chances either with legal questions or with the temper of its people and its legislators. (Pages 94 to 101, Final Report.) Those are the real reasons for the commission's recommendation of the fourth method as against the third method in section 5219, R. S. No one of them is even mentioned or suggested by the appellant. Appellant would have this court believe that the selection of the fourth method instead of the third method was attributable to the existence of large quantities of tax-exempt bonds held by taxpayers. There is nothing in the Governor's message to the legislators summoning them into special session, nothing in the draft of the constitutional amendment proposed by the commission to the Legislature, nothing in the constitutional amendment determined upon by the Legislature for submission to the people of the State at the general election in November, 1928, and nothing in the official statement concerning the proposal distributed to every voter in California, which indicated that the State was concerned with a new method of treating interest from tax-exempt bonds, or that interest from tax-exempt bonds even figured in the proposal.

Reverting to what the commission did say in its report concerning holdings of tax-exempt bonds, it is to be noted that the reference thereto is applied only to banks. It would have been "serious" in one sense

had the commission recommended the third method as against the fourth method in section 5219, R. S., but the seriousness would not have resided in the fact that the State would thereby have obtained less revenue than it needed or desired. The situation would have been serious because, as already explained, there was a tremendous advantage for the banks to be relieved from the share tax and placed under an income tax or under a franchise tax, and the commission deemed it unwise and unfair from the point of view of equity and success in having its recommendations approved by the people and by the Legislature, not from the point of view of additional revenue, to recommend the fourth method as contrasted with the third. Appellant does not call the attention of the court to the statement by the commission that "in the case of corporations other than banks" it is "not of vital importance" whether or not interest from tax exempts is included in the tax base. (Page 276, Final Report.)

At the time the Commission prepared in special report in August, 1928, the *Macallen* case was pending, and at that point of the report just noted reference to that case is made. The presence of that reference in the report can not be reconciled reasonably with appellant's claim that by indirection and guile California sought indirectly to accomplish, by an ingenious scheme for treating tax exempts, that which it could not do directly under some other tax plan. The same comment may be made of the sug-

gested form of constitutional amendment submitted by the Commission to the Governor of California and by him in turn to the Legislature sitting in extraordinary session, for in paragraph (5) thereof it is provided that the Legislature shall define net income, including "if possible" the entire net income received from all sources. (Page 290, Final Report.) From this it is plain that the purpose of the Commission was not to effect a new, artful and indirect method of taxing interest from tax exempts. Had such been the purpose of the Commission, the language of its proposed constitutional amendment would have directed that net income be defined to include income from all sources. The amendment which the Legislature proposed, and which the people adopted, subsequent to the Commission's recommendation, likewise did not compel the inclusion of interest from tax exempts in the tax base. The language thereof is that the Legislature shall define net income, and that it "may" define it to include "the entire net income received from all sources." Again, if the major objective of the Commission, or of the Governor, or of the Legislature, or of the people of California, had been to set up a plan of franchise tax whereby interest from tax exempts would be comprehended within the net income base, the language of the constitutional amendment would have been positive and mandatory in that regard, and the Legislature would not have been left free, as it was, to exercise its discretion as to whether that

interest should or should not be included in the tax base. Appellant, therefore, can derive neither comfort nor support from the language of the Commission, even if this court should be inclined to look behind the language of the Bank and Corporation Franchise Tax Act of 1929.

The Legislature of California meeting in regular session in 1929, immediately following the adoption of section 16 of Article XIII of the California Constitution, can not, therefore, be said to have acted upon any constitutional *direction* in constructing the Bank and Corporation Franchise Tax Act, for section 16 of Article XIII contains no such direction. Nor can it fairly be said that the Legislature, in so acting, followed any positive or definite *recommendation* of the Commission. For reasons already discussed fully, the Commission expressed its *preference* for the fourth method in section 5219 R. S., as compared with the third method therein authorized, but when it came to a concrete proposal and recommendation to the Legislature in the form of a suggested constitutional amendment it left open the matter of the scope of the base by which the franchise tax should be measured. When the proposal, modified by the Legislature, and transformed by the people into an integral part of the Constitution, demanded legislative action, the Legislature was entirely free in the matter of dealing with interest from tax exempts, and it elected to establish a base comprehending income from all sources including bonds

of all kinds, but in doing so it exercised, unhampered, its own discretion, and its motive or purpose in acting as it did act can not fairly be attributed to events preceding the enactment of the statute.

There were the suggestions of the Commission for the consideration of the Legislature. It was stated to the Legislature by Dr. Robert M. Haig, Adviser and Director of Research of the Technical Staff, cooperating with the California Tax Commission of 1927, that interest from tax-exempt bonds is an exceedingly important item in a tax which is applied to banks; but, as already observed, that statement was not predicated upon any positive recommendation of the Commission or upon any direction in the matter by the constitutional amendment to the Legislature; and, in addition, the statement was applied to banks only, and that for the reasons hereinabove discussed, and not to general corporations of the class in which appellant is embraced. Of far greater importance, however, is the fact that there was before the Legislature for consideration a long line of decisions of this court, appearing definitely to establish the validity of that feature of a pure franchise or corporation excise tax which measures the amount of the imposition by a percentage of a net income base in which is included interest from tax-exempt bonds and other bonds of all kinds.

Society for Savings vs. *Coite*, 6 Wall. 594, *supra*;

Provident Institution vs. *Massachusetts*, 6 Wall. 611, *supra*;
Hamilton Co. vs. *Massachusetts*, 73 U. S. 632, *supra*;
Home Insurance Co. vs. *New York*, *supra*;
Flint vs. *Stone-Tracy*, *supra*;
McCoach vs. *Mineville Ry. Co.*, 228 U. S. 295, 387 (1913);
Stratton's Independence, Ltd. vs. *Howbert*, 231 U. S. 399, 416 (1913);
Interboro Transit Co. vs. *Sohmer*, 237 U. S. 276, 284 (1915);
Equitable Life Soc. vs. *Pennsylvania*, 238 U. S. 143, 147 (1915);
Anderson vs. *42 Broadway Co.*, 239 U. S. 69, 72 (1915);
Fidelity and Colonial Trust Co. vs. *Louisville*, 245 U. S. 54, 59 (1917).
Doyle vs. *Mitchell Co.*, 247 U. S. 179, 182 (1918);
Ray Copper Co. vs. *U. S.*, 268 U. S. 373, 376 (1925).

With this explanation and statement of California's tax policy toward corporations for fifty years prior to November, 1928; of the reasons and purposes underlying and leading up to the change effected in the Constitution of California by the addition of section 16 to Article XIII in November, 1928, and of the situation confronting the Legislature of California when it enacted the statute here under attack, we can say, as we do say to this court in perfect conscience, that the provision in the Bank and Corporation Franchise Tax Act of 1929 for the

inclusion in the tax base of the interest from the bonds here in question was merely "fortuitous" and "incidental" to the main purpose of that statute and of its parent provision in the organic law of the State, namely, section 16 of Article XIII.

IV

Educational Films Corporation vs. Ward

This brief would be incomplete without some reference to *Educational Films Corporation* vs. *Ward*, 282 U. S. 379.

Without that case our position would be the same, inasmuch as we contend that our case is governed by the principles in *Flint* vs. *Stone-Tracy* and not by the *Macallen* case. Nevertheless, there is a close parallel between our case and the *Films* case and between the California tax situation and the New York tax situation and the *Films* case undoubtedly lends added strength to our position. It distinguishes the *Macallen* case and leaves no doubt as to the precise basis of that decision. The *Films* case also removes any doubt that may have existed as to *Flint* vs. *Stone-Tracy* being overruled, and establishes the principles of that case more firmly than ever.

The *Films* case involved a New York statute providing for an annual tax on domestic corporations for the privilege of exercising their franchises in the State in a corporate or organized capacity. The tax is payable in advance for each year and is at the

rate of four and one-half per cent of so much of the corporation's entire net income for its preceding fiscal year as is, under other sections, allocated to the business carried on within the State. Under the statute net income embraces "income from any source" and "is presumably the same as the entire net income" reported for income taxation to the United States "plus * * * dividends on stocks or any interest received on bonds of any character."

Subdivision 3 of section 208 of the statute provides "the term 'entire net income' means the total net income, including all dividends received on stocks, and all interest received from Federal, State, municipal or other bonds * * *."

The plaintiff in that case was the owner of copyrights granted by the United States upon motion picture films and had received royalties for the licensing of them. The company contended that the tax was invalid on the ground that the copyrights and all income derived from them were immune from State taxation and that the tax measured by net income was void so far as the measure included income from the copyrights, because it constituted a tax on Federal instrumentalities.

The question of contract between the State and the taxpayer was not involved, but it is readily apparent that in other particulars the case affords a close parallel to the case at bar. This is made apparent by what was said by this court in its opinion upholding the New York statute and declaring the

tax to be valid. This court held, as we ask the court to hold in this case, that the tax was not a direct tax upon allocated income of a corporation in a given year, but a tax for the privilege of doing business in one year measured by the allocated income accruing from the business in the preceding year. In that connection this court said:

> "If we look to the operation of the present statute, it is plain that it can have no application independent of the corporation's enjoyment of the privilege of exercising its franchise. * * * Since it can be levied only when the corporation both seeks or exercises the privilege of doing business in one year and has been in receipt of net income during its preceding fiscal year, the tax, whatever descriptive terms are properly applicable to it, obviously is not exclusively on income apart from the franchise."

This court, referring to *Flint* vs. *Stone-Tracy* and allied cases, including *Society for Savings* vs. *Coite*, then said that it has been consistently held that the privilege of exercising a corporate franchise is no less an appropriate object of taxation by one government merely because the corporate property or net income which is made the measure of the tax may chance to include the obligations of the other or the income derived from them, and that the constitutional power of one government to reach this permissible object of taxation may not be curtailed because of the indirect effect which the tax may have upon the other. The court then mentioned other

forms of excise taxes which have been upheld upon like principles, although the statutory measure of the tax included securities constitutionally immune from any form of direct taxation. Among the other forms referred to were a State inheritance or legacy tax, although measured by the value of the United States bonds which are transmitted (*Plummer* vs. *Coler,* 178 U. S. 115); an inheritance tax levied by a State on a bequest to the United States (*U. S.* vs. *Perkins,* 163 U. S. 625); an inheritance tax by the United States on a bequest to a municipality (*Snyder* vs. *Bettman,* 190 U. S. 249); State laws, taxing to stockholders at full value shares in National banks, although the banks own tax-exempt United States bonds (*Van Allen* vs. *Assessors,* 3 Wall. 573); the tax on net income, including receipts from exports in the computation of the income (*Peck & Co.* vs. *Lowe,* 247 U. S. 165); a State income tax on income, including income from interstate commerce (*United States Glue Co.* vs. *Oak Creek,* 247 U. S. 321); a State tax upon the franchise of a corporation measured by its receipts from transportation properly apportioned to the business done within the State, although it includes receipts from interstate commerce (*Maine* vs. *Grand Trunk Ry. Co.,* 142 U. S. 217); a tax on franchises of domestic corporations measured by corporate property, even though such property be without the State (*Kansas City Ry.* vs. *Kansas City,* 240 U. S. 227).

Referring to the last mentioned type of tax this court said:

> "So well settled is this last mentioned application of the doctrine that an excise may be measured by tax immune property, that an appeal in which such a tax was assailed on the very grounds urged here, was dismissed *per curiam* during the present term. No. 108, *Nebraska ex rel. Beatrice Creamery Co.* vs. *Marsh,* decided Oct. 20, 1930."

Further quoting from the *Films* case it was said by this court:

> "It is said that there is no logical distinction between a tax laid on a proper object of taxation, measured by a subject matter which is immune, and a tax of like amount imposed directly on the latter; but it may be said with greater force that there is a logical and practical distinction between a tax laid directly upon all of any class of government instrumentalities, which the Constitution impliedly forbids, and a tax such as the present which can in no case have any incidence, unless the taxpayer enjoys a privilege which is a proper object of taxation, and which would not be open to question if its amount were arrived at by any other nondiscriminatory method. * * *
>
> Having in mind the end sought, we can not say that the rule applied by this court for some 70 years—that a nondiscriminatory tax upon corporate franchises is valid, notwithstanding the inclusion of tax-exempt property or income in the measure of it—has failed of its purpose, or

has worked so badly as to require a departure from it now; or that the present tax, viewed in the light of actualities, imposes any such real or direct burden on the Federal Government as to call for the application of a different rule."

This court then proceeded to distinguish the *Macallen* case, showing that the decision in that case was rested "on the distinguishing fact that the tax-exempt securities were included in the measure of the franchise tax by virtue of an amendment to the taxing statute, which, it was held, was specifically intended to reach the income from tax-exempt national and municipal bonds which has previously not been included in the measure of the tax."

This court then said that the case was thus brought within the purview of

Miller vs. *Milwaukee*, 272 U. S. 713,

where it was held that:

"If the avowed purpose or self-evident operation of a statute is to follow the bonds of the United States and to make up for its inability to reach them directly by indirectly achieving the same result, the statute must fail, even if but for its purpose or special operation it would be perfectly good."

And the court qualified that statement as, in fact, it had been qualified in the *Macallen* case, by saying (quoting from the *Miller* case):

"A tax very well may be upheld as against any casual effect it may have upon the bonds of the

United States when passed with a different intent and not aimed at them."

In the *Films* case the court held that before the New York statute was amended its was sufficiently broad to include income from copyrights within the measure of the tax and that neither before nor after the amendments did it make any mention of copyrights or their income and that there was nothing to suggest that the Legislature could at any time have had in mind the addition of income from copyrights to the measure of the tax, or that the statute or the amendments thereto had been adopted for the purpose of subjecting it *pro tanto* to the burden of the tax.

Thus was the *Films* case distinguished from the *Macallen* case and for like reasons and upon like principles we respectfully urge that the case now at bar may be even more readily distinguished from the *Macallen* case. In view of the history of the California legislation, to which we have herein made extended reference, we believe that this court can not fail to be convinced beyond any shadow of a doubt that California had no "major purpose" to strike at nontaxable bonds or the income therefrom; that there existed on the part of California, its people, or its Legislature, no ulterior or sinister motive such as would invalidate its legislation, but that quite to the contrary the treatment of tax exempts was but incidental and fortuitous in connection with the avowed and obvious effort of California

to rearrange her tax structure in respect to corporations on a legally permissible basis, and not only that, but upon a basis that would tend to remove existing inequalities in the tax system and result in the accomplishment of that purpose greatly to be desired, namely, the equalization of taxes as between banks and general business corporations.

In view of appellant's frequent references to the reports of the California Tax Commission and in view of the stress which appellant lays upon its contention that California's major purpose was to reach exempt income and lay a tax thereon, thereby accomplishing indirectly what it could not accomplish directly, we desire to make this final observation:

That no group of men, experts or otherwise, charged, as was the California Tax Commission, with the duty and responsibility of investigating the systems of revenue and taxation in force in California and in other states; of examining into any and all matters pertaining to the subjects of revenue and taxation in California; of making findings and conclusions based upon such investigations, and of making recommendations to the Legislature as to necessary changes in the existing system of taxation, including a report upon the matter of the relative burden of taxes borne by general property values and such property values as are taxed directly by the State under its existing system of taxation—no group with such responsibilities could claim to have performed the functions delegated to it unless it

devoted serious and conscientious attention to questions involved in the matter of tax-exempt property, the principles governing the immunity of certain property from taxation and the opportunities afforded the State to treat such tax-exempt property in a manner legally and constitutionally permissible. Any report submitted by such a group which did not deal fully and carefully with the subject of tax-exempt property would necessarily be incomplete and of little, if any, practical value to the members of the Legislature concerned with the subject of taxation. On the other hand, the value of the report to the Legislature and the value of the recommendations made by the investigating body would be in direct proportion to the thoroughness with which that body performed its duties.

Considering the great emergency existing in California, to which reference has already been made herein, it was all the more incumbent upon the California Tax Commission to make a very accurate and thorough investigation so that its conclusions and recommendations to the Legislature would be sound and might safely be made the basis of recommendations to the people for constitutional amendments or the basis for statutes to be enacted by the Legislature. Difficulties are not overcome by ignoring them and seeking short cuts. Rather, it may be said, difficulties will be increased and magnified by a deliberate refusal to recognize or treat with them. Therefore, in performing its duties, the California Tax Commis-

sion could not ignore the subject of tax exempts, and in treating of them in its report it did no more than any other intelligent commission would have done, and should have done, and had that commission done less it would have been subject to just criticism and condemnation. The fact, therefore, that it did its work in a thorough and comprehensive manner should not now be made the basis for the claim that California's motive in readjusting her tax system was ulterior or sinister or that there was, in fact, any motive other than as hereinabove explained a sincere and laudable desire to correct deficiencies in the tax policy of the State, to relieve the existing inequalities, and to bring about a fair, just and equitable distribution of the tax burden.

CONCLUSION

From this necessarily extended narrative of the history of the pertinent tax provisions of the California Constitution and of the Bank and Corporation Franchise Tax Act, and from this review and analysis of the authorities, the conclusion is irresistible that California did *not* inaugurate in 1928 a new tax system designed to accomplish by indirection that which it had not theretofore done or that which it was powerless theretofore to do, and that the relation of interest from tax exempts to the amount payable to California by banks and general corporations under the Bank and Corporation Franchise Tax Act is indeed "fortuitous and incidental" in the history and in the structure of that enactment.

The conclusion that the tax in question is not a property tax or a tax on tax-exempt bonds, or on the interest therefrom completely disposes of section 1¾ of Article XIII, for that section, as has been shown, applies only to property taxes and has never been intended or understood to affect other forms of taxes. Since section 1¾ of Article XIII deals with property taxes only and since the tax in question is not a property tax, it follows that neither section 16, Article I, of the State Constitution nor section 10, Article I, of the Federal Constitution is transgressed by section 16 of Article XIII and or by the Bank and Corporation Franchise Tax Act.

Appellant's argument that section 16 of Article XIII is retroactive is bound up in appellant's claim that there has been an impairment of the obligation of contract clause.

On the theory that section 1¾ of Article XIII comprehended or created an obligation to exempt corporations from the kind of tax provided for in the Bank and Corporation Franchise Tax Act (which, as we have said under Heading III hereof, we strenuously deny), it must be apparent that such obligation, being contrary to the present policy of the State and unsupported by adequate, if by any, consideration, was removed by the express provisions of section 16 of Article XIII.

We respectfully submit that the judgment of the Supreme Court of the State of California should be affirmed.

U. S. WEBB,
Attorney General of the State of California,

H. H. LINNEY,
Deputy Attorney General,
Attorneys for Appellee.

FRANK L. GUERENA,
of Counsel.

EXHIBIT "A"

GOVERNOR'S LETTER TO LEGISLATORS

SACRAMENTO, August 16, 1928.

DEAR SENATOR _____:

I am calling the Legislature into special session, to convene Tuesday morning, September 4th, at 11 o'clock. The object of the session is the consideration of a constitutional amendment which may be submitted to the voters at the general election of next November. The submission of such an amendment clearly should not be delayed until the election two years hence.

I am advised that some amendment such as is proposed is unquestionably necessary to provide a legal method for the taxation of banks, our present method being invalid under the interpretation of the federal law in decisions of the United States Supreme Court. It is also proposed to provide a low rate of taxation for intangibles, two previous laws dealing with this problem having been adjudged unconstitutional by the Supreme Court of this state.

It goes without saying that no Governor likes to call a special session of the Legislature. Certainly none would have been called in this instance except for the absolute necessity of promptly putting our bank taxes on a sound and legal basis. I am informed by the Tax Commission that any delay in this matter will place in jeopardy no less than $22,000,000 of state revenue, probably all of which may be saved by immediate action.

Enclosed please find the formal call for a special session, together with an advance copy of my message to the Legislature, which I wish you would read very carefully as a continuation and amplification of this personal letter. I am also mailing by separate enclosure the report of the California Tax Commission of this subject, in order that you may determine for yourself whether there is any course of action possible other than the one embodied in their recommendation.

Yours very sincerely,

C. C. YOUNG, Governor.

ADVANCE MESSAGE TO THE LEGISLATURE

SACRAMENTO, August 16, 1928.

To the Members of the Senate and Assembly:

Though naturally reluctant to call you from your homes into a special session, I feel that under existing circumstances both you and the citizens of the state whom you represent could justly call me culpably negligent if I should fail to do so. The government of California is facing a most serious fiscal problem which involves its financial stability; and, after months of study by the Tax Commission, it is manifest that there is no way of solving this problem except by the adoption of a necessary constitutional amendment at next November's election.

The trouble has arisen through the discovery that our method of bank taxation adopted in 1910 has virtually become a dead letter on account of its conflict with federal law—a conflict made clear by recent decisions of the United States Supreme Court. Though this specifically applies to national banks, it practically applies to state banks as well, since it is easily seen that a taxed state banking system can not exist in competition with tax-free national banks, and that if national banks should escape taxation our state banks would speedily nationalize. The annual tax involved amounts to nearly $5,000,000, and the years involved run from 1926 to such time as a valid system of bank taxation is established.

At the outset it should be made clear that California state expenditures are being held down to the absolute minimum, just as they were two years ago, and that the work of the Tax Commission therefore consists largely in equalizing the burden of taxation rather than in finding new sources of revenue. At the same time, existing revenues are barely sufficient to meet these minimum expenditures; and, if we should lose any considerable portion of the $22,000,000 the Tax Commission finds involved in this bank-tax problem, we would have to make it up from some other source now presumably already bearing its full share of the tax burden. This is a thing which we must avoid at all hazards, and I am satisfied we can avoid it by sufficiently prompt and decisive action.

To make this subject as clear as possible I shall try to set forth: I, Why our system of bank taxation must be changed; II, How it may be changed; and III, Why it is imperative that it be changed now, rather than at the regular session next January.

I. Why Must the System Be Changed?

The law underlying national bank taxation may be found in section 5219 of the Federal Statutes, reading in part as follows:

> "Sec. 5219. The legislature of each state may determine and direct, subject to the provisions of this section, the manner and place of taxing all the shares of national banking associations located within its limits. The several states may (1) tax said shares, or (2) include dividends derived therefrom in the taxable income of an owner or holder thereof, or (3) tax such associations on their net income, or (4) according to or measured by their net income, provided the following conditions are complied with: * * *
>
> "In the case of a tax on shares the tax imposed shall not be at a greater rate than is assessed upon other moneyed capital in the hands of individual citizens of such state coming into competition with the business of national banks. * * *
>
> "In the case of a tax on or according to or measured by the net income of an association, * * * the rate shall not be higher than the rate assessed upon other financial corporations nor higher than the highest of the rates assessed by the taxing state upon mercantile, manufacturing and business corporations, doing business within its limits. * * *"

Thus it will be noted that there are two distinct ways by which a national bank may be taxed—a tax based upon the value of its shares and a tax based upon its net income. California in 1910 adopted the first method, then and for years afterward the only method permitted by the federal law as it then stood. In 1925 the legislature passed its 7 per cent intangibles law, and the Federal Supreme Court, in the so-called Wisconsin and Minnesota cases, through decisions handed down

in March, 1927, made it clear that such a law imposed upon the banks a greater tax "than is assessed upon other moneyed capital"; whereupon many of the banks paid their taxes under protest.

The Legislature in 1927 tried to correct this situation by fixing upon intangibles the same rate as had been fixed for banks; but it failed, in the opinion of a majority of the State Supreme Court, to provide for an equitable distribution of the proceeds of the tax on intangibles. Moreover, the fact was overlooked that by constitutional amendment California had exempted from taxation mortgages, which again might be construed to give to "other moneyed capital" a tax advantage over banks, and thus invalidate any bank tax based on shares. Inasmuch as it is obviously not advisable to repeal the tax exemption of mortgages, our constitutional amendment and laws for bank taxation have become dead letters and will continue to be dead letters unless the situation is met by new enactments. This would leave the national banks of the state without any state taxation whatever; while, as shown above, what is true for national banks must also practically be true for state banks.

II. How May the System Be Changed?

Our bank taxation based on shares having thus become invalid, we are thrown back upon the alternative method based on net income, and included as number (4) in the federal law by an amendment passed in 1926. This method, though only two years old, has already been adopted by other states, notably New York and Massachusetts. The California Tax Commission, after a most thorough study, has determined that no other method of bank taxation is practicable in this state.

By referring to the federal law as quoted above, it will be noted that in taxing banks on their net income the rate must not be higher than the rate upon the net income of other financial or business corporations—such corporations as are now paying the indefinite and unsatisfactory "state franchise tax"; though these corporations shall be permitted to deduct, as an offset to the state tax, the local taxes paid on personal property. It is important, therefore, to compute the rate on net income producing an equivalent of the amount paid by

banks under the old law, as well as the rate on net income equivalent to the amount paid by other corporations in franchise and personal property taxes.

A full and careful analysis shows that banks have been paying taxes equivalent on the average to 11.6 per cent of their net income, while other corporations of all classes have been paying taxes equivalent on the average to 4.4 per cent of their net income. However, these other corporations differ widely as to classes; for, while oil corporations, for instance, average 6.7 per cent, investment and finance corporations are paying on the average less than 1 per cent. Moreover, in the same class corporations differ widely in the weight of their taxes.

This shows a very great need for equalizing corporation taxes, and shows, also, that many corporations have been escaping without bearing their fair share of the tax burden. It is difficult to see, for instance, why banks should be taxed on the average 11.6 per cent—many of them over 25 per cent—of their net income, while certain other financial corporations are escaping with a tax of less than one-tenth of one per cent of their net income.

Inasmuch as the federal law provides that banks shall be taxed on their net incomes at no higher rate than that assessed against other corporations, what shall be the uniform rate fixed upon for both banks and these other corporations? Shall it be, for instance, 11.6 per cent, the average rate now paid by the banks? The answer is "No," partly because it will be too heavy a tax for many of these other corporations, and more especially because it will bring in more money than the state needs or has a right to expect. The purpose is to insure that the new bank tax together with the new corporation tax shall equal, but not exceed, the old bank tax plus the old corporation franchise tax.

The Tax Commission and its staff have figured that our present revenue will be maintained by a 4 per cent tax on the net income of both banks and other corporations, it being remembered that for these other corporations personal property taxes are in large measure to be deducted. If congress hereafter should change the federal law so as to provide a different or modified method for taxing banks, or different rates as between banks and other corporations, the proposed constitu-

tional amendment has been made sufficiently elastic to permit the legislature to act accordingly.

Let it be remembered that this 4 per cent rate is upon a net income rather than a gross income, and that it is a lower rate than that adopted by any other state, lower, for example, than the rate in Massachusetts or New York. Let it be noted that upon a corporation capital with a 6 per cent net income, a 4 per cent tax on that income is less than a one-fourth of one per cent tax on the capital—certainly a very small sum to pay for the privilege of doing a corporation business in this state. As a very prominent Los Angeles business man has just written to me: "Any corporation which is now paying only a nominal tax should be willing to pay as much tax as kindred corporations are paying, since the fact that they have escaped so far is no valid reason why they should continue to escape."

III. Why Should the System Be Changed Now?

Why can not this proposed amendment wait until next year's session of the Legislature when the entire tax question is being considered? I have been asked this question in good faith, and it is deserving of an answer. The main reason is that such delay would cost the state a very vast sum of money, probably all of which will be saved by action at the present time.

A constitutional amendment submitted now can be voted upon in November and at once go into effect, thus giving us immediately a valid system of bank taxation. A constitutional amendment submitted at the next regular session would not be voted upon for two years, thus leaving us without bank taxes for that length of time. Although many of the banks have protested or brought suit for the return of taxes paid in 1926, 1927, and 1928, their real interest is doubtless not in escaping from any just burden of taxes, but rather in securing a valid and stabilized method of bank taxation. Should such a method be at once adopted, there is little probability that the banks will proceed with their suits for a return of taxes already paid.

On the other hand, bankers have informed me that, if no new method of bank taxation is now adopted, they must refuse to pay any more taxes under the present invalid law, and that to be consistent they must follow up their suits for the return

of taxes already collected under the same invalid law. Thus by delaying we will not only lose all possibility of bank taxes for the next two years, but will involve the state in troublesome and expensive litigation to retain the bank taxes of the past two or three years. The Tax Commission estimates the amount in jeopardy to be more than $22,000,000, but feels that probably this entire amount can be saved by the submission and adoption of the necessary constitutional amendment at the approaching November election.

Incidentally, having abandoned the attempt to tax banks on the basis of shares, the way is now cleared for the adoption of a law for the taxation of intangibles, as called for by the voters at the general election of 1924. Accordingly a provision for the taxation of intangibles can be incorporated in this same constitutional amendment, and may be found in the tentative amendment at the end of the Tax Commission Report which has been placed in your hands. I would most strongly urge a study of this report, since it will enable you to determine whether our bank-tax revenues can be preserved by any other action than the one proposed.

IV. Conclusion.

I feel that enough has been said to show the necessity of a special legislative session at this time. The Tax Commission has spent months in trying to find some other remedy, but to no avail. The session has been postponed until after the primary election in order to remove it from the field of politics. It is not a political issue. It is not an administration issue. It is simply a financial crisis which has arisen without the fault of anyone, but which will be the fault of all of us if we do not take immediate and effective steps to settle it. I believe that none of us will seek to evade our manifest responsibility.

Very respectfully submitted.

C. C. YOUNG,
Governor.

EXHIBIT "B"

ARGUMENT IN FAVOR OF THE ADOPTION OF ASSEMBLY CONSTITUTIONAL AMENDMENT No. 1

This is an emergency measure, to save for the people some $22,000,000 in bank taxes, which otherwise the general taxpayer would have to make up. It will not increase total state taxes or revenues. It is submitted by unanimous vote of the Legislature to meet a crisis resulting from recent decisions of the United States Supreme Court.

These decisions practically nullify our present method of taxing banks and relieve banks from all taxes until that method is changed. This measure makes the only possible change, adopting the method already used in New York and other states, and meeting the requirement of federal law that national banks be taxed according to net income and at a rate no higher than is applied to other corporations. It is made sufficiently flexible to allow changes of rates or method whenever permitted by amendments in federal laws.

The amendment will accomplish the following results:

1. It will increase the bank taxes from nothing—their present status—to about $2,000,000 a year. Although lower than the necessarily abandoned bank tax revenue, the new tax is as high as can fairly be levied against other corporations whose tax burden legally must equal that of banks.

2. It will increase taxes about $2,000,000 a year on financial corporations, largely affiliated with banks and now escaping almost tax-free. Thus banks and their subsidiary corporations will together pay nearly as much as under the old illegal method—in some cases, actually more.

3. It will increase by about $1,000,000 a year the tax on certain other corporations, hitherto paying an insufficient, uncertain, and unsatisfactory franchise tax. Many of these, such as large newspaper corporations, are generously supporting this proposition as just and fair.

4. It will by these three increases protect the state against the loss threatened through federal court decisions and protect the general taxpayer against the burden of replacing this loss.

5. It will decrease the tax on a majority of the smaller corporations, now too often bearing a tax burden disproportionate to their ability to pay.

6. It will not affect the taxes of the general taxpayer. Banks and corporations will together pay just what they formerly paid before the bank tax was invalidated. Banks will continue to pay local taxes on their real estate, and corporations on both real and personal property. Without this amendment, banks would pay no state tax and their financial corporations little, leaving general taxpayers to make up the deficit.

7. It is therefore a new sort of tax law, preventing tax burdens from being increased instead of increasing them.

8. Finally, it alone makes possible a low but collectible tax on so-called "intangibles," as approved by the voters four years ago. This will not only attract to California new citizens and new capital, but will draw out of hiding an immense body of now concealed securities, and, by making them available for local taxation, lighten the tax burden on other property. This amendment specifically provides for such tax relief.

Accordingly, to save to the state a possible $22,000,000 in bank taxes which the general taxpayer would otherwise have to make up, to provide a valid bank tax for the future, to equalize corporation taxes, and to permit taxes on intangibles, *vote* "YES."

H. C. NELSON,
State Senator, First District.

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